Exam # 7857; May 8, 2008; Corporate Tax; Professor Bogdanski

#3
<u>7/16 sale of P stock by Frank (F) to Xcorp</u>

On first blush, it looks as though F merely sold his stock to X for FMV – so it looks fair – he would recognize a capital gain under 1222 on the sale of his capital asset of $300k ($400k sale price minus his $100k basis allocated to the ½ sold). Assuming he has held the stock long enough – this would be LTCG taxed at 15% → so he would have to pay $45k in taxes. But, in law school life is never that simple….

F owns > 50% of P outright prior to the sale and constructively he owns 75% (because of the 318a1 family attribution of his daughter's 100 shares – 300/400 shares). There is no attribution between F and his sister under 318a1 because there is no sibling attribution. There is no attribution between F and R either because there is no 318a1 family attribution between in-laws. Therefore, F is a controlling shareholder in P.

F doesn't own any X stock outright, but under 318a2 (which attributes from entities – P – to their owners – F), F constructively owns 67.5% of X. Therefore, he is also a controlling shareholder in X.

Therefore, under 267b2 – F and X could be attacked as being related parties and the IRS may attempt to recast this transaction between arguably related corps, with F representing P in the transaction, as a cash distribution. But, since FMV was paid for the stock, this is unlikely.

There is another way the IRS may attack this – it deals with the problem X owning any of P's stock at all – this is apparently corporate inversion. Because P owns 90% of X – it is essentially a parent (P) – Sub (X) relationship. There is a question as to the legality of the sub owning the shares of the parent.

Anyways – under 304a2, if a shareholder in control of the parent (F) sells shares of the parent to the sub (in order to get money out of the corp without paying a dividend and being able to use his basis in the stock to offset gain), it is treated as a redemption of the stock of the parent even though the parent didn't redeem any of its stock. It is treated as a dividend in this situation because there is plenty of E&P ($500k) in the parent (P) and F still has control of the parent (even though it appears he has dropped from owning 50% to 33% directly – constructively he still is attributed his daughter's shares under 318a1 and he actually still has 67% (200/300 shares)

Because this is treated as a redemption we must delve into the all too fun 302b tests to determine whether it still has a chance of receiving sale or exchange treatment (where F could still use his basis to offset gain), rather than dividend treatment where he will be taxed at the 15% preferential rate with no basis usage allowance. It wasn't a complete termination of his interest – so no 302b3 – and getting a waiver of family attribution won't help F here because even if we could waive the attribution from his daughter – he would still own 100 shares directly. Because he still has 67% control of voting stock in P (directly and constructively) – he won't meet the requirements of 302b2 because he still owns more than 50% of the total voting power and waiver of family attribution only applies to complete terminations. He won't meet 302b1 either because

his redemption is essentially equivalent to a dividend – he owned 75% before and he owns 67% afterward. This likely isn't a meaningful reduction in interest because he still owns 89.3333% of the total voting power he had prior to the redemption and Rev Ruling 75-502 indicates that when a redemption nearly misses 302b2 (which this one arguably misses by a long shot) there may be a meaningful reduction when a majority shareholder's interest is reduced to a deadlock. This isn't the case here – he still has outright control when attribution is considered. Finally it doesn't appear to meet 302b4 partial liquidation because there is no indication that there has either been a genuine contraction of the business (for the Judicial test) or that P has sold off one of its 2 businesses (not that there was any indication that there even were 2 businesses) (for the 302e2 safe harbor). F may argue that the subsequent liquidation of X constitutes one of the above – but mere distribution of sub stock is insufficient and it happened nearly 6 months later.

Therefore – the redemption will be treated as a dividend of $400k to F under 301 and P has sufficient E&P ($500k) to make this entire amount taxable as a dividend under 301c1. Thus, F will have to pay tax at the 15% preferential dividend rate and he will be precluded from using his stock basis to offset gain (the unused basis from the 100 shares sold to X will be reallocated evenly amongst his remaining 100 shares in P). F will end up paying $60k in tax – but that is what he gets for attempting to be a "scammer."

1/9 Liquidation of X

Under 332b1, the liquidation of a subsidiary is generally a tax free event if, when the sub's liquidation plan is adopted and up until the final distribution, the parent owns 80% of the total voting power of the sub and 80% of the value of the outstanding stock. This fits here because P owns 90% of the sub stock. Therefore the distribution is tax free to P, who takes the cash, the appreciated commercial rental real estate and the P stock which it subsequently cancels. Under 334b, P will take a carryover basis in each of these assets - $70k in the commercial rental real estate, and $400k in its own stock and P's basis in its X stock disappears. The built-in gain in the rental real estate is preserved in the hands of P. Also, under 381a1 – P will inherit X's E&P (which is at least $100k because X was profitable in 2008 – and generated additional current E&P). The X E&P will be added to P's existing $500k of E&P. P will also take over Net operating loss carryovers from X. This appears to have been done pursuant to a preexisting liquidation plan and it appears to have been accomplished in a "one shot" distribution under 332b2 – within one taxable year (2009).

Under 337 the liquidating sub, X, doesn't recognize gain on the distributions to P.

But, it distributed property with a built in loss of $40k to R, a minority shareholder – so 332 doesn't apply to him. Under 331a – the distribution at the shareholder level to R will be treated as a sale or exchange and he can use his $30k basis to offset his $60k realized amount – thus he will recognize $30k LTCG because of the nature of the asset (publicly traded securities). Under 334a, R will take a tax cost basis in the assets received equal to the FMV of the assets ($60k). Under 336a, X would typically recognize a loss of $40k on the deemed sale, but it will be prevented by the 336d3 loss limitation.

Time is out – thanks for a great class – and Fin …HAY!....have a great summer!