

CHAPTER

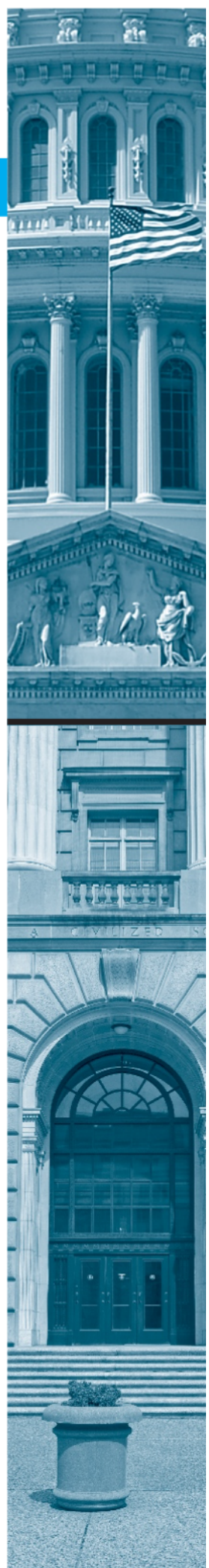
4

CORPORATE NONLIQUIDATING DISTRIBUTIONS

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- 1** Ask the key questions pertaining to corporate liquidations
- 2** Calculate a corporation's earnings and profits (E&P)
- 3** Determine the tax consequences of nonliquidating distributions
- 4** Determine the tax consequences of stock dividends and the issuance of stock rights
- 5** Decide whether a stock redemption should be treated as a sale or a dividend
- 6** Explain the tax treatment of preferred stock bailouts
- 7** Assess the applicability and tax consequences of Sec. 304 to stock sales
- 8** Identify tax planning opportunities in nonliquidating distributions
- 9** Comply with procedural rules for nonliquidating distributions



CHAPTER OUTLINE

Nonliquidating Distributions in General...4-2
 Earnings and Profits (E&P)...4-3
 Nonliquidating Property Distributions...4-8
 Stock Dividends and Stock Rights...4-13
 Stock Redemptions...4-16
 Preferred Stock Bailouts...4-27
 Stock Redemptions by Related Corporations...4-30
 Tax Planning Considerations...4-33
 Compliance and Procedural Considerations...4-36

A corporation may distribute money, property, or stock to its shareholders. Shareholders who receive such distributions might have to recognize ordinary income, capital gain, or no taxable income at all. The distributing corporation might be required to recognize gain or loss when making the distribution. How the corporation and its shareholders treat distributions for tax purposes depends on not only what the corporation distributes but also on the circumstances surrounding the distribution. Was the corporation in the process of liquidating? Was the distribution made in exchange for some of the shareholder's stock?

This chapter addresses distributions made when a corporation is not in the process of liquidating. It discusses the tax consequences of the following types of distributions:

- Distributions of cash or other property where the shareholder does not surrender any stock
- Distributions of stock or rights to acquire stock of the distributing corporation
- Distributions of cash or other property in exchange for the corporation's own stock (i.e., stock redemptions)

Chapter C:6 discusses liquidating distributions, and Chapter C:7 discusses distributions associated with corporate reorganizations.

NONLIQUIDATING DISTRIBUTIONS IN GENERAL

OBJECTIVE 1

Ask the key questions pertaining to corporate liquidations

When a corporation makes a nonliquidating distribution to a shareholder, the shareholder must answer the following three questions:

- What is the amount of the distribution?
- To what extent is this amount treated as a dividend?
- What is the basis of the distributed property, and when does its holding period begin?

In addition, the distributing corporation must answer the following two questions:

- What are the amount and character of gain or loss the corporation must recognize?
- What effect does the distribution have on the distributing corporation's earnings and profits (E&P) account?

SELF-STUDY QUESTION

How does a shareholder classify a distribution for tax purposes?

ANSWER

Distributions are treated as follows: (1) dividends to the extent of corporate E&P, (2) return of capital to the extent of the shareholder's stock basis, and (3) gain from the sale of stock.

A brief summary of the rules for determining the taxability of a distribution follows, along with a simple example.

Section 301 requires a shareholder to include in gross income the amount of any corporate distribution to the extent it is treated as a dividend. Qualified dividends received by a noncorporate shareholder are subject to a maximum 20% tax rate (and possibly an additional 3.8% on net investment income). Section 316(a) defines a dividend as a distribution of property made by a corporation out of its earnings and profits (E&P), which are discussed in the next section of this chapter. Section 317(a) defines property broadly to include money, securities, and any other property except stock or stock rights of the distributing corporation. Distributed amounts that exceed a corporation's E&P are treated as a return of capital that reduces the shareholder's basis in his or her stock (but not below zero). Distributions exceeding the shareholder's basis are treated as gain from the sale of the stock. If the stock is a capital asset in the shareholder's hands, the gain is capital in character.

EXAMPLE C:4-1 ►

On March 1, Gamma Corporation distributes \$60,000 in cash to each of its two equal shareholders, Ellen and Bob. At the time of the distribution, Gamma's E&P is \$80,000. Ellen's basis in her stock is \$25,000, and Bob's basis in his stock is \$10,000. Ellen and Bob each recognize \$40,000 ($0.50 \times \$80,000$) of dividend income. This portion of the distribution reduces Gamma's E&P to zero. The additional \$20,000 that each shareholder receives is treated first as a return of capital and then as a capital gain. The following table illustrates the relevant calculations:

	<u>Ellen</u>	<u>Bob</u>	<u>Total</u>
Distribution	\$60,000	\$60,000	\$120,000
Dividend income ^a	(40,000)	(40,000)	(80,000)
Remaining distribution	\$20,000	\$20,000	\$ 40,000
Return of capital ^b	(20,000)	(10,000)	(30,000)
Capital gain ^c	\$ -0-	\$10,000	\$ 10,000

^aSmaller of E&P allocable to the distribution or the distribution amount.

^bSmaller of remaining distribution amount to the shareholder or his or her stock basis.

^cAny amount that exceeds the shareholder's basis in his or her stock.

EARNINGS AND PROFITS (E&P)

OBJECTIVE 2

Calculate a corporation's earnings and profits (E&P)

The term E&P is not defined in the IRC. Its meaning must be gleaned from judicial opinions, Treasury Regulations, and IRC provisions relating to how certain transactions affect E&P.

To some extent, E&P measures a corporation's economic ability to pay dividends to its shareholders. Distributions are presumed to be made out of the corporation's E&P, unless the corporation reports no E&P.

TYPICAL MISCONCEPTION

Because E&P is such an important concept in many corporate transactions, one would assume that corporations know exactly what their E&P is. However, many corporations do not compute their E&P on a regular basis.

CURRENT EARNINGS AND PROFITS

A corporation's E&P falls into two categories: current and accumulated. As explained below, current E&P is calculated annually. Accumulated E&P is the sum of undistributed current E&P balances for all previous years reduced by the sum of all previous current E&P deficits and any distributions the corporation made out of accumulated E&P. Distributions are deemed to have been made first out of current E&P and then out of accumulated E&P to the extent that current E&P is insufficient.

EXAMPLE C:4-2

Zeta Corporation was formed in Year 1. Its current E&P balance (or deficit) and distributions for each year through Year 4 are as follows:

<u>Year</u>	<u>Current E&P (Deficit)</u>	<u>Distributions</u>
1	\$(10,000)	-0-
2	15,000	-0-
3	18,000	\$9,000
4	8,000	-0-

The corporation is deemed to have made the \$9,000 distribution out of its Year 3 current E&P balance. At the beginning of Year 4, Zeta's accumulated E&P balance is \$14,000 (– \$10,000 + \$15,000 + \$18,000 – \$9,000). At the beginning of Year 5, Zeta's accumulated E&P balance is \$22,000 (\$14,000 + \$8,000).

Computing Current E&P. A corporation computes its current E&P on an annual basis at the end of each year. The starting point for computing current E&P is the corporation's taxable income or net operating loss (NOL) for the year. Taxable income or the NOL must be adjusted to derive the corporation's economic income or loss (current E&P) for the year. For example, federal income taxes must be deducted from taxable income to derive E&P. Because the corporation must pay these taxes to the U.S. government, they reduce the amount available to pay dividends to shareholders. On the other hand, tax-exempt income must be added to taxable income (or the NOL) because, even though not taxable, such income increases the corporation's ability to pay dividends.

Table C:4-1 lists some of the adjustments a corporation must make to taxable income (NOL) to derive current E&P. Some of these adjustments are explained below.¹

¹ The adjustments are based on rules set forth in Sec. 312 and related Treasury Regulations.

▼ **TABLE C:4-1**
Computation of Current E&P

Taxable income	
Plus:	<i>Income excluded from taxable income but included in E&P</i>
	Tax-exempt interest
	Proceeds from a life insurance contract in which the corporation is named as the beneficiary
	Recoveries of bad debts and other deductions from which the corporation received no tax benefit
	Federal income tax refunds from prior years
Plus:	<i>Income deferred to a later year when computing taxable income but included in E&P in the current year</i>
	Deferred gain on installment sales. Such gain is included in E&P in the year of sale.
Plus or minus:	<i>Income and deduction items that must be recomputed for E&P purposes</i>
	Income on long-term contracts based on the percentage of completion rather than the completed contract method
	Depreciation on personal and real property based on:
	The straight-line method for other than MACRS property
	The alternative depreciation system for MACRS property
	Excess of percentage depletion over cost depletion
Plus:	<i>Deductions allowed for taxable income purposes but denied for E&P purposes</i>
	Dividends-received deduction
	NOL carryovers, charitable contribution carryovers, and capital loss carryovers applied in the current year
	Interest expense carryovers applied in the current year.
Minus:	<i>Expenses and losses that are denied for taxable income purposes but allowed for E&P purposes</i>
	Federal income taxes
	Premiums on life insurance contracts in which the corporation is named as the beneficiary
	Excess capital losses not currently deductible
	Excess charitable contributions not currently deductible
	Excess business interest expenses not currently deductible
	Expenses related to the production of tax-exempt income
	Nondeductible losses on sales to related parties
	Nondeductible penalties and fines
	Nondeductible political contributions and lobbying expenses
Current E&P balance (or deficit)	

Income Excluded from Taxable Income but Included in E&P. Although certain items of income are excluded from taxable income, these items must be included in E&P if they increase the corporation's ability to pay dividends. For example, a corporation's current E&P includes both tax-exempt interest and life insurance proceeds. Current E&P also includes the recovery of an item deducted in a previous year if the deduction produced no tax benefit for the corporation and therefore was excluded from its taxable income.

EXAMPLE C:4-3 ►

Ace Corporation deducted \$10,000 of bad debts in Year 1. In the same year, Ace generated a \$50,000 NOL (including the \$10,000 bad debt deduction) that carries over. Consequently, it derived no tax benefit from the deduction. In Year 2, Ace recovers \$8,000 of the debt owed to it. Ace excludes the \$8,000 from its gross income for Year 2 because it derived no tax benefit from the bad debt deduction in Year 1. However, Ace must add the \$8,000 to its taxable income when computing current E&P for Year 2 because the NOL reduced current E&P in Year 1. (Ace also reduces its NOL carryover by \$8,000 because of the recovery.) ◀

ADDITIONAL COMMENT

If Ace deducts the entire NOL carryover in Year 2, it also would add back to taxable income the remaining \$42,000 NOL deduction.

Income Deferred to a Later Year When Computing Taxable Income but Included in E&P in the Current Year. Gains and losses on property transactions generally are included in E&P in the same year they are recognized for taxable income purposes.

EXAMPLE C:4-4 ▶ In a like-kind exchange, Stone Corporation exchanges investment property with a \$12,000 basis and an \$18,000 fair market value (FMV) for \$1,000 cash and investment property worth \$17,000. Stone recognizes a \$1,000 gain—the amount of boot received—and defers the remaining \$5,000 of realized gain. Stone includes the recognized gain in both taxable income and current E&P. It does not include the deferred gain in either taxable income or current E&P. ◀

In the case of an installment sale, the entire realized gain must be included in current E&P in the year of the sale. This rule applies to sales made by dealers and nondealers.

EXAMPLE C:4-5 ▶ In the current year, Tally Corporation sells land with a \$12,000 basis and \$20,000 FMV to Rick, an unrelated individual. Rick makes a \$5,000 down payment this year and promises to pay Tally, in each of the next three years, an additional \$5,000 plus interest at the prevailing market rate on the unpaid balance. Tally's realized gain is \$8,000 (\$20,000 – \$12,000). For taxable income purposes, Tally currently recognizes \$2,000 of gain $[(\$8,000 \div \$20,000) \times \$5,000]$ under the installment method for nondealers. For E&P purposes, Tally includes all \$8,000 of its realized gain in current E&P. Thus, in computing current E&P, Tally increases taxable income by \$6,000. As it receives the installments over the next three years, Tally will recognize the remaining \$6,000 of gain (\$2,000 per year) for taxable income purposes. It will reduce E&P by \$2,000 in each of those years because it included in E&P all \$8,000 in the current year. ◀

SELF-STUDY QUESTION

In computing taxable income and E&P, different depreciation methods are often used. What happens when the taxpayer sells such assets?

ANSWER

The taxpayer must calculate gain or loss for taxable income and E&P purposes separately. This difference is an added complexity in making E&P calculations.

Income and Deduction Items That Must Be Recomputed for E&P Purposes. Some deductions are computed differently for E&P purposes than for taxable income purposes, thereby requiring adjustments.

- ▶ E&P must be computed under the percentage of completion method even where the corporation uses the completed contract method for taxable income purposes.
- ▶ Depreciation must be recomputed under the alternative depreciation system of Sec. 168(g). This rule applies even for amounts deducted as bonus depreciation. However, the cost of property expensed under Sec. 179 must be recovered ratably over a five-year period starting with the month in which it was expensed. Other personal property must be depreciated over the property's class life under the half-year convention. Real property must be depreciated over a 40-year period under the straight-line method and mid-month convention.

EXAMPLE C:4-6 ▶ In January of last year, Radon Corporation placed in service equipment costing \$25,000. For regular tax purposes, the corporation expensed the \$25,000 under Sec. 179. However, for E&P purposes, the corporation expensed only \$5,000 (\$25,000/5). Thus, in last year's E&P calculation, the corporation would have increased its taxable income amount by \$20,000 (\$25,000 – \$5,000) to derive last year's current E&P (a positive adjustment). In the current year's E&P calculation (and for the next three years), the corporation reduces its taxable income amount by \$5,000 to derive its current E&P balance (a negative adjustment). If Radon instead deducted the entire \$25,000 as bonus depreciation, last year's E&P depreciation would have been \$1,043 ($\$25,000 \times 0.0417$), and the E&P adjustment would have been a positive \$23,957 ($\$25,000 - \$1,043$). The current year adjustment would be a negative \$2,083 ($\$25,000 \times 0.0833$). These E&P calculations assume straight-line depreciation and a 12-year recovery period under the alternative depreciation system. See Appendix C, Table 11 for depreciation rates. ◀

- ▶ Cost depletion must be used for E&P purposes even where percentage depletion is used for taxable income purposes.
- ▶ Intangible drilling costs must be capitalized and amortized over 60 months.

BOOK-TO-TAX ACCOUNTING COMPARISON

Many corporations use retained earnings to measure the taxability of their dividend payments. However, because retained earnings are based on financial accounting concepts, E&P may represent a different amount and may provide a different measure of the corporation's economic ability to pay dividends.

Deductions Allowed for Taxable Income Purposes but Denied for E&P Purposes. Some deductions allowed for taxable income purposes are not allowed for E&P purposes.

- ▶ The dividends-received deduction is denied for E&P purposes because it does not reduce the corporation's ability to pay dividends. In the computation of E&P, this deduction must be added back to taxable income.
- ▶ NOL, charitable contribution, business interest expense, and capital loss carryovers that reduce current taxable income cannot be deducted to derive E&P. These excess losses or deductions reduce E&P in the year they are incurred or taken.
- ▶ Deduction and amortization of organizational expenses are disallowed for E&P purposes.

EXAMPLE C:4-7 ► Thames Corporation's taxable income is \$500,000 after deductions for the following items: a \$10,000 NOL carryover from last year and \$20,000 for dividends received. To compute current E&P, Thames must add these items (totaling \$30,000) back to its taxable income. As a result, current E&P is \$530,000. ◀

Expenses and Losses Denied for Taxable Income Purposes but Allowed for E&P Purposes. Some expenses and losses that are not deductible for taxable income purposes are deductible for E&P purposes.

- For taxable income purposes, federal income taxes are not deductible. For E&P purposes, however, federal income taxes are deductible in the year they accrue if the corporation uses the accrual method and in the year they are paid if the corporation uses the cash method.

EXAMPLE C:4-8 ► Perch Corporation, an accrual basis taxpayer, earns taxable income of \$100,000 on which it owes \$21,000 of federal income taxes. In computing current E&P, Perch reduces taxable income by the amount of these taxes, or \$21,000. ◀

- For E&P purposes, charitable contributions are fully deductible. Thus, when current E&P is computed, taxable income must be reduced by any charitable contributions disallowed because of the 10% limitation.

EXAMPLE C:4-9 ► Dot Corporation computes \$25,000 of taxable income before any charitable contribution deduction. Dot contributed \$10,000 to the Red Cross. For taxable income purposes, Dot's charitable contribution deduction is limited to \$2,500 because of the 10% limitation. Thus, taxable income is \$22,500 (\$25,000 – \$2,500). However, Dot deducts the entire \$10,000 in computing current E&P. In this computation, it must subtract the remaining \$7,500 from taxable income to arrive at current E&P of \$15,000 (\$22,500 – \$7,500). In a later year, when the corporation deducts the \$7,500 carryover to compute taxable income, it must add that amount back to taxable income to derive current E&P. ◀

- Premiums paid on insurance policies covering the lives of key corporate personnel (net of any increase in the cash surrender value) are not deductible when computing taxable income but are deductible when computing E&P.
- Capital losses exceeding capital gains cannot be deducted when computing taxable income but can be deducted when computing current E&P.
- Business interest expenses in excess of limitations cannot be deducted when computing taxable income but can be deducted when computing current E&P.
- Nondeductible expenses related to the production of tax-exempt income (e.g., interest charges to borrow money to purchase tax-exempt securities) are deductible when computing E&P.
- Losses on related party sales that are disallowed under Sec. 267 are allowed when computing E&P.
- Fines, penalties, and political contributions that are nondeductible for taxable income purposes are deductible for E&P purposes.

The foregoing items constitute only a partial list of adjustments that must be made to taxable income to compute current E&P. The basic rule is that an adjustment to taxable income must be made so that current E&P reflects the corporation's economic ability to pay dividends.

DISTINCTION BETWEEN CURRENT AND ACCUMULATED E&P

A distinction must be made between current and accumulated E&P. A nonliquidating distribution is taxed as a dividend if made out of either current or accumulated E&P. Corporate distributions are deemed to be made first out of current E&P and then out of accumulated E&P to the extent that current E&P is insufficient.² If current E&P is sufficient to cover all distributions during the year, each distribution is treated as a taxable

² The distinction between current and accumulated E&P is explained in Reg. Sec. 1.316-2.

dividend. This rule applies even where the corporation reports a deficit in its beginning accumulated E&P account. Current E&P is computed as of the last day of the tax year without reduction for distributions during the year.

EXAMPLE C:4-10 ▶

TAX STRATEGY TIP

A corporation with an accumulated E&P deficit and current E&P balance may want to postpone distributions to a later year to avoid dividend treatment in the current year. See Example C:4-53 later in this chapter.

At the beginning of the current year, Water Corporation has a \$30,000 accumulated E&P deficit. For the entire year, Water generates current E&P of \$15,000. During the year, Water distributes \$10,000 in cash to its shareholders. The \$10,000 distribution is treated as a taxable dividend to the shareholders because it is deemed to be made entirely out of current E&P. At the beginning of the next tax year, Water's accumulated E&P deficit is \$25,000 (\$30,000 E&P deficit reduced by \$5,000 of undistributed current E&P) computed as of the last day of the previous year. ◀

If distributions during the year exceed current E&P, current E&P is allocated on a pro rata basis regardless of when during the year the distributions occurred. Distributions exceeding current E&P are deemed to be made in chronological order out of accumulated E&P (if any). Distributions exceeding current and accumulated E&P are treated as a return of capital and reduce the shareholder's stock basis. However, such distributions cannot create an E&P deficit, which results only from losses. These rules are particularly relevant if stock changes hands during the year and total E&P is insufficient to cover all distributions.

EXAMPLE C:4-11 ▶

At the beginning of the current year, Cole Corporation has \$20,000 of accumulated E&P. For the entire year, Cole's current E&P is \$30,000. On April 10, Cole distributes \$20,000 in cash to Bob, its sole shareholder. On July 15, Cole distributes an additional \$24,000 in cash to Bob. On August 1, Bob sells all of his Cole stock to Lynn. On September 15, Cole distributes \$36,000 in cash to Lynn. Cole's current and accumulated E&P must be allocated among the three distributions as follows:

<i>Date</i>	<i>Distribution Amount</i>	<i>Current E&P</i>	<i>Accumulated E&P</i>	<i>Dividend Income</i>	<i>Return of Capital</i>
April 10	\$20,000	\$ 7,500	\$12,500	\$20,000	\$ -0-
July 15	24,000	9,000	7,500	16,500	7,500
September 15	36,000	13,500	-0-	13,500	22,500
Total	<u>\$80,000</u>	<u>\$30,000</u>	<u>\$20,000</u>	<u>\$50,000</u>	<u>\$30,000</u>

The current E&P allocated to the April 10 distribution is calculated as follows:

$$\$30,000 \text{ (Current E\&P)} \times \frac{\$20,000 \text{ (April 10 distribution)}}{\$80,000 \text{ (Total distributions)}}$$

Note that the total amount of dividends paid by Cole equals \$50,000, the sum of \$30,000 of current E&P and \$20,000 of accumulated E&P. Current E&P is allocated among all three distributions on a pro rata basis, whereas accumulated E&P is reduced first by the April 10 distribution (\$12,500), then by the July 15 distribution, so that no accumulated E&P is available for the September 15 distribution. Thus, Bob's dividend income from Cole is \$36,500 (\$20,000 + \$16,500). He also receives a \$7,500 return of capital that reduces his stock basis accordingly. Lynn's dividend income from Cole is \$13,500. She also receives a \$22,500 return of capital that reduces her stock basis accordingly. Bob cannot determine his gain on the stock sale until after the end of the year. He must wait until he knows the extent to which the April 10 and July 15 distributions reduce his stock basis. ◀

If the corporation generates both a current E&P deficit and an accumulated E&P deficit, none of the distributions is treated as a dividend. Instead, all distributions are treated as a return of capital to the extent of the shareholder's stock basis. Distributions exceeding this basis are taxed as a capital gain.

EXAMPLE C:4-12 ▶

At the beginning of the current year, Rose Corporation has a \$15,000 accumulated E&P deficit. Rose's current E&P deficit is \$20,000. Rose distributes \$10,000 on July 1. The distribution is treated not as a dividend but rather as a return of capital to the extent of the shareholder's stock basis. Any amount exceeding stock basis is taxed as a capital gain. Rose's accumulated E&P deficit on January 1 of next year is \$35,000 because the distribution was not made out of E&P and because the negative balance in the current E&P account is transferred to the accumulated E&P account at the end of the current year. ◀

SELF-STUDY QUESTION

When is E&P measured for purposes of determining whether a distribution is a dividend?

ANSWER

Usually at year-end. However, if a current deficit exists, the E&P available for measuring dividend income is determined at the distribution date.

If the corporation has a current E&P deficit and a positive accumulated E&P balance, it must net the two accounts at the time of the distribution to determine the dividend amount.³ The deficit in current E&P that has accrued up through the day before the distribution reduces the accumulated E&P balance on that date. If the balance remaining after the reduction is positive, the distribution is treated as a dividend to the extent of the lesser of the distribution amount or the E&P balance. If the E&P balance is zero or negative, the distribution is treated as a return of capital to the extent of the shareholder's stock basis and capital gain to the extent the distribution exceeds stock basis. If the actual deficit in current E&P to the date of distribution cannot be determined, the current E&P deficit is prorated on a daily basis to the day before the distribution.

EXAMPLE C:4-13 ►

Assume the same facts as in Example C:4-12 except that Rose Corporation has a \$15,000 accumulated E&P balance. Unless information indicates otherwise, the current E&P deficit of \$20,000 accrues on a daily basis. The amount of the July 1 distribution treated as a dividend is calculated as follows:

<u>Date</u>	<u>Distribution Amount</u>	<u>Accumulated E&P</u>	<u>Dividend Income</u>	<u>Return of Capital</u>
January 1	\$ -0-	\$15,000	-0-	-0-
July 1	10,000	(9,918) ^a	\$5,082	\$4,918
Total	<u>\$10,000</u>	<u>\$ 5,082^b</u>	<u>\$5,082</u>	<u>\$4,918</u>

^a $181/365 \times \$20,000 = \$9,918$ —the current E&P deficit accrued up to the distribution date. (The denominator in the 181/365 fraction assumes that the current year is not a leap year.)

^b $\$15,000 - \$9,918 = \$5,082$ —accumulated E&P at beginning of year minus the current E&P deficit accrued up to the distribution date.

? STOP & THINK

Question: Why is it necessary to keep separate balances for current and accumulated E&P, and why is it necessary to track E&P to individual distributions?

Solution: Separate balances are necessary because of the way dividends are accounted for. If total current and accumulated E&P is less than the total distributions to the shareholders, E&P must be allocated to all distributions during the year to determine the amount of each distribution that should be treated as a dividend. When no change in the shareholder's stock ownership occurs during the year and all distributions are proportional to stock ownership, an E&P allocation is needed only to track each shareholder's stock basis. Tracking E&P to individual distributions is necessary to determine the taxability of a particular distribution when a change in a shareholder's stock ownership occurs because current E&P is allocated on a pro rata basis and accumulated E&P is allocated chronologically. As a result of the chronological allocation, a greater portion of distributions early in a tax year may be taxed as a dividend relative to distributions later in the year. On the other hand, because accrued current E&P deficits offset accumulated E&P balances, a smaller portion of distributions later in a tax year may be taxed as a dividend relative to distributions earlier in the year.

NONLIQUIDATING PROPERTY DISTRIBUTIONS

OBJECTIVE 3

Determine the tax consequences of nonliquidating distributions

CONSEQUENCES OF NONLIQUIDATING PROPERTY DISTRIBUTIONS TO THE SHAREHOLDERS

Property includes cash, securities, and any other property except stock in the corporation making the distribution (or rights to acquire such stock).⁴ When a corporation distributes property to its shareholders, the following three questions must be answered:

³ Reg. Sec. 1.316-2(b).

⁴ Sec. 317(a).

KEY POINT

The amount of the distribution is measured by the FMV of the property less liabilities assumed (but not below zero) because this net amount represents the real economic value received by the shareholder.

- ▶ What is the amount of the distribution?
- ▶ To what extent is this amount treated as a dividend?
- ▶ What is the basis of the property distributed to the shareholder, and when does its holding period begin?

For cash distributions, these questions are easy to answer. The distribution is the amount of cash distributed, which is treated as a dividend to the extent of the corporation's current and accumulated E&P. The E&P account is reduced by the amount distributed, and the shareholder's basis in the cash received is its face value. The distributing corporation recognizes no gain or loss on cash distributions.

When the corporation distributes property, such as land or inventory, the above questions are more difficult to answer. Neither the distribution amount nor the shareholder's basis in the property is immediately apparent. The corporation must recognize gain (but not loss) on the distribution, and the impact of the distribution on the corporation's E&P, as well as the taxability of the distribution, must be ascertained. The following sections set forth rules that address these issues.

When the corporation distributes property to a shareholder, the distribution amount is the property's FMV, determined as of the distribution date.⁵ The amount of any liability assumed by the shareholder in the distribution, or to which the distributed property is subject, reduces the distribution amount, but never below zero. The distribution amount is treated as a dividend to the extent of the distributing corporation's E&P.

The shareholder takes a FMV basis in any property received. This basis is not reduced by any liabilities assumed by the shareholder or to which the property is subject.⁶ The holding period for the property begins on the day after the distribution date and does not include the distributing corporation's holding period.

EXAMPLE C:4-14

▶ Post Corporation has \$100,000 of current and accumulated E&P. On March 1, Post distributes to Meg, its sole shareholder, land with a \$60,000 FMV and a \$35,000 adjusted basis. The land is subject to a \$10,000 liability, which Meg assumes. The distribution amount is \$50,000 (\$60,000 – \$10,000), all of which is treated as a dividend to Meg because it does not exceed Post's E&P balance. Meg's basis in the property is its \$60,000 FMV, and her holding period for the property begins on March 2. ◀

**STOP & THINK**

Question: When a corporation distributes property, why do liabilities reduce the amount of income realized by the shareholder but not the shareholder's adjusted basis in the property?

Solution: The liabilities reduce the amount of income realized, but not the shareholder's adjusted basis, because the distribution is analogous to the corporation's transferring an asset that it has financed with debt. Recall that financing the purchase of an asset has no bearing on the asset's cost basis. On the other hand, assuming a liability is tantamount to the transferee's settling the liability with the transferee's own funds, and thus receiving less value from the transferor.

Topic Review C:4-1 summarizes the tax consequences of a nonliquidating distribution to the shareholders.

KEY POINT

Property distributions may trigger income at both the shareholder and the distributing corporation level. This result is another example of the double taxation that exists in our corporate tax system.

CONSEQUENCES OF PROPERTY DISTRIBUTIONS TO THE DISTRIBUTING CORPORATION

Two questions must be answered with respect to a corporation that distributes property:

- ▶ What amount and character of gain or loss must the distributing corporation recognize?
- ▶ What effect does the distribution have on the corporation's E&P?

⁵ Sec. 301(b).

⁶ Sec. 301(d).

TOPIC REVIEW C:4-1

Tax Consequences of a Nonliquidating Distribution to the Shareholders

1. The amount of a distribution equals cash received plus the FMV of any noncash property received reduced by any liabilities assumed or acquired by the shareholder.
2. The distribution is treated as a dividend to the extent of the distributing corporation's current and accumulated E&P. Any distribution amount exceeding E&P is treated as a return of capital that reduces the shareholder's stock basis (but not below zero). Any additional excess is treated as a capital gain.
3. The shareholder's basis in the property received is its FMV.
4. The shareholder's holding period for the property begins the day after the distribution date.

Corporate Gain or Loss on Property Distributions. When a corporation distributes property that has appreciated in value, the corporation must recognize gain for both tax purposes and current E&P purposes as though the corporation had sold the property for its FMV. On the other hand, a corporation does not recognize a tax loss when it distributes property that has depreciated in value even though the corporation would have recognized a loss upon selling the property.⁷

EXAMPLE C:4-15 ►

Silver Corporation distributes to Mark, a shareholder, land (a capital asset) worth \$60,000. Silver's adjusted basis in the land is \$20,000. Upon distributing the land, Silver recognizes a \$40,000 (\$60,000 – \$20,000) capital gain, as if Silver had sold the property. If the land instead had a \$12,000 FMV, Silver would not have recognized a loss. ◀

TAX STRATEGY TIP

Rather than distribute loss property, the corporation should consider selling it and distributing the proceeds. The sale will allow the corporation to deduct the loss.

If the distributed property is subject to a liability or the shareholder assumes a liability in the distribution, for the purpose of calculating gain, the property's FMV is deemed to be no less than the amount of the liability.⁸

EXAMPLE C:4-16 ►

Assume the same facts as in Example C:4-15 except the land's FMV instead is \$25,000, and the land is subject to a \$35,000 mortgage. For the purpose of calculating gain, the land's FMV is deemed to be \$35,000 because this value cannot be less than the liability amount. Thus, Silver Corporation's gain is \$15,000 (\$35,000 – \$20,000), the extent to which the land's deemed FMV exceeds its adjusted basis.⁹ ◀

TAX STRATEGY TIP

If possible, a corporation should avoid distributing property subject to a liability exceeding the property's FMV because of the potential gain recognition caused by the excess liability.

Effect of Property Distributions on the Distributing Corporation's E&P. Distributions have two effects on E&P:¹⁰

- When a corporation distributes appreciated property to its shareholders, it must increase E&P by the E&P gain, which is the excess of the property's FMV over its adjusted basis for E&P purposes. Because a property's E&P adjusted basis may differ from its tax basis (as discussed earlier in this chapter), this E&P gain may differ from the corporation's recognized gain for taxable income purposes.
- If the E&P adjusted basis of the noncash asset distributed equals or exceeds its FMV, E&P is reduced by the asset's E&P adjusted basis. If the FMV of the asset distributed exceeds its E&P adjusted basis, E&P is reduced by the asset's FMV. In either case, the E&P reduction is net of any liability to which the asset is subject or that the shareholder assumes in the distribution. E&P also is reduced by the income tax liability incurred on any gain recognized.¹¹

⁷ Sec. 311(a).

⁸ Sec. 311(b)(2).

⁹ The tax treatment of the shareholder is not entirely clear. Section 336(b), which Sec. 311(b)(2) makes applicable to nonliquidating distributions, specifically states that this liability rule applies only for determining the corporation's gain or loss. Thus, its applicability does not seem to extend to Sec. 301(d), which gives the shareholder a FMV basis in the distributed property. Some commentators have suggested that a strict interpretation of the statutory provision that gives the shareholder an actual FMV basis, rather than the

greater liability basis, produces an illogical result. (See B. C. Randall and D. N. Stewart, "Corporate Distributions: Handling Liabilities in Excess of the Fair Market Value of Property Remains Unresolved," *The Journal of Corporate Taxation*, 1992, pp. 55–64.) Also, in principle, given that the liability exceeds the distributed property's FMV, the shareholder's amount distributed should be zero, resulting in no dividend.

¹⁰ Secs. 312(a) and (b).

¹¹ Secs. 312(a) and (c).

EXAMPLE C:4-17 ▶

Brass Corporation distributes to its shareholder, Joan, property with a \$25,000 adjusted basis for taxable income purposes, a \$22,000 adjusted basis for E&P purposes, and a \$40,000 FMV. The property is subject to a \$12,000 mortgage, which Joan assumes. In the distribution, Brass recognizes a \$15,000 (\$40,000 FMV – \$25,000 tax adjusted basis) gain for taxable income purposes. For E&P purposes, Brass's E&P is increased by an \$18,000 (\$40,000 FMV – \$22,000 E&P adjusted basis) E&P gain and reduced by the amount of income taxes paid or accrued by Brass on the \$15,000 tax gain. E&P is further reduced by the \$28,000 (\$40,000 FMV – \$12,000 liability) net value of the distribution.

BOOK-TO-TAX ACCOUNTING COMPARISON

The distributing corporation reports dividends-in-kind at their FMV for financial accounting (book) purposes. For book purposes, the distributing corporation recognizes the difference between the property's FMV and its carrying value as a gain or loss. For tax purposes, however, the corporation recognizes gains but not losses.

A special rule applies when a corporation distributes its own obligations (e.g., its notes, bonds, or debentures) to a shareholder. In such case, the distributing corporation's E&P is reduced by the principal amount, not the fair market value, of the obligations.¹²

Topic Review C:4-2 summarizes the tax consequences of a nonliquidating distribution to the distributing corporation.

CONSTRUCTIVE DIVIDENDS

A constructive dividend (or deemed distribution) is the manner in which the IRS or the courts might recharacterize an excessive corporate payment to a shareholder to reflect the true economic benefit conferred upon the shareholder. As a result of the recharacterization, the IRS or courts usually recast a corporate-shareholder transaction as an E&P distribution, deny the corporation an offsetting deduction, and treat all or a portion of the income recognized by the shareholder as a dividend. Ordinarily, a corporate dividend involves a direct, pro rata distribution to all shareholders and is declared by the board of directors. By contrast, a constructive dividend need not be direct or pro rata, nor be declared by the board of directors.

Constructive dividends generally are deemed to be paid in the context of a closely held corporation where the shareholders (or relatives of shareholders) and management groups overlap. In such situations, the dealings between the corporation and its shareholders are likely to be less formal and subject to closer review than dealings between a publicly held corporation and its shareholders. Constructive dividends also may occur in the context of a publicly held corporation.

ADDITIONAL COMMENT

The incentive to disguise dividends as salary, however, is somewhat diminished with the reduced tax rate on dividends.

Intentional Efforts to Avoid Dividend Treatment. The IRS's recharacterization of a payment as a constructive dividend often is in response to a shareholder's attempt either to bail out E&P without subjecting the corporate income to taxation at the shareholder level or to obtain a deduction at the corporate level that otherwise would be disallowed. If a corporation generates sufficient E&P, dividend distributions are fully taxable to the shareholder but are not deductible by the distributing corporation. For this reason, shareholders may try to

TOPIC REVIEW C:4-2**Tax Consequences of a Nonliquidating Property Distribution to the Distributing Corporation**

1. When a corporation distributes appreciated property, it must recognize gain as if it sold the property for its FMV immediately before the distribution.
2. For gain recognition purposes, a property's FMV is deemed to be at least equal to any liability to which the property is subject or that the shareholder assumes in connection with the distribution.
3. A corporation recognizes no loss when it distributes to its shareholders property that has depreciated in value.
4. The corporation increases current E&P by any E&P gain (FMV – E&P basis) resulting from the distribution of appreciated property, and it decreases current E&P by the taxes incurred on the tax gain (FMV – tax basis) recognized on the distribution.
5. The corporation reduces its E&P by the amount of cash and FMV of any appreciated property distributed, and it reduces E&P by the adjusted basis of distributed property whose adjusted basis exceeds its FMV. In either case, the reduction amount is offset by any liabilities associated with the property.

¹² Sec. 312(a)(2).

**ETHICAL POINT**

A CPA should always be an advocate for his or her client if the question of whether a constructive dividend has been paid is in doubt (i.e., when the facts and the law are sufficiently gray and the taxpayer's position has reasonable support).

ADDITIONAL COMMENT

The government requires that, when loans exist between a corporation and its shareholders, the loans must bear a reasonable interest rate. If a "below-market" interest rate loan exists, the IRS will impute a reasonable rate of interest (Sec. 7872).

disguise a dividend as a salary payment. Without recharacterization, the payment would be taxable to the shareholder-employee and deductible by the distributing corporation as long as the payment is reasonable in amount. Shareholders also may try to disguise dividends as loans to themselves. Without recharacterization, a loan would be neither deductible by the corporation nor taxable to the shareholder. If the IRS recharacterizes either payment as a dividend, the payment is taxable to the shareholder and nondeductible by the corporation.

Unintentional Constructive Dividends. Some constructive dividends are inadvertent. Shareholders may not realize that the benefits they receive from the corporation are effectively taxable dividends until a tax advisor or the IRS examines the transactions. If a payment in the form of a salary, loan, lease, etc. is recast as a dividend, corresponding adjustments must be made at the corporate and shareholder levels. These adjustments may increase the shareholder's taxable income (e.g., because the distribution has been recharacterized as a dividend rather than a loan) or increase the distributing corporation's taxable income (i.e., because dividends are not deductible). Transactions most likely to be recast and treated as dividends are described below.

Loans to Shareholders. Loans to shareholders may be viewed as disguised dividends unless the shareholders can prove that the loans are bona fide. Whether a loan is bona fide ordinarily depends on the shareholder's intent at the time he or she makes the loan. To prove that the loan is bona fide (and thus to avoid recharacterization of the loan as a dividend), the shareholder must show that he or she intends to repay the loan. Factors indicative of an intent to repay include

- Recording the loan on the corporate books
- Evidencing the loan with a written note
- Charging a reasonable rate of interest
- Scheduling regular payment of principal and interest

Factors that suggest the loan is *not* bona fide include

- Borrowing on "open account" (i.e., the shareholder borrows from the corporation with no fixed repayment schedule, whenever he or she needs cash)
- Failing to charge a market rate of interest
- Failing to enforce the regular payment of interest and principal
- Paying advances in proportion to stockholdings
- Paying advances to a controlling shareholder

If the corporation lends money to a shareholder and then, after a period of time, cancels the loan, the amount cancelled might be treated as a dividend to the extent of the corporation's E&P. If the corporation charges a below market interest rate, the IRS could impute interest on the loan. In such case, the corporation would be deemed to have earned interest income on the loan, and the shareholder would be allowed a deduction for interest deemed paid.

Excessive Compensation Paid to Shareholder-Employees. Shareholders may be compensated for services in the form of salary, bonus, or fringe benefits. Ordinarily, the corporate employer may deduct such compensation as long as it represents an ordinary and necessary business expense and is reasonable in amount. However, if the IRS finds the compensation to be excessive, the excess amount will not be deductible by the corporation but still will be taxable to the shareholder. Depending upon the circumstances, this amount may be treated as a dividend or simply be included in the gross income of the recipient. No hard and fast rules offer guidance for determining when compensation is excessive. As a result, the issue frequently is litigated.

Before a tax law change in the early 2000s, the IRS's main focus was the corporation's deducting the excess amount of wages paid to a shareholder-employee. At that time, a shareholder-employee recognized ordinary income regardless of whether the excess was characterized as compensation or a dividend. Because the tax rate on qualified dividends is now lower than the tax rate on salaries and wages, the corporation still will lose the deduction for excess compensation, but the IRS is unlikely to classify the excess as a dividend. Instead, the IRS

probably will treat the excess as compensation to the shareholder-employee even though the corporation is not allowed to deduct it.¹³

Insufficient Salary Amounts. With the corporate tax rate at 21% and the top individual tax rate at 37%, shareholder-employees of closely held corporations may have an incentive to minimize the salaries paid to themselves to avoid the higher tax rate on salary income. This possibility could lead the IRS to question whether salaries are too low rather than excessive.

Excessive Compensation Paid to Shareholders for the Use of Shareholder Property. As with compensation, corporate payments to shareholders for the use of property (i.e., rents, interest, and royalties) are deductible under Sec. 162(a) if they are ordinary, necessary, and reasonable in amount. The corporation may not deduct any amount exceeding what it would have paid to an unrelated party in an arm's-length transaction.

Corporate Payments for the Shareholder's Benefit. If a corporation pays the personal obligation of a shareholder, the corporate payment may result in gross income to the shareholder. Such a payment may cover the shareholder's personal debt, expenses in connection with the shareholder's personal residence, expenses incurred for the improvement of the shareholder's real property, or an obligation personally guaranteed by the shareholder.

In addition, if the IRS denies a corporate deduction, the disallowed deduction may result in gross income to the shareholder if the expenditure associated with the deduction conferred an economic benefit upon the shareholder. Examples of such expenditures are unsubstantiated travel and entertainment expenses; club dues; and automobile, airplane, and yacht expenses related to the shareholder-employee's personal use.

Bargain Purchase of Corporate Property. If a shareholder purchases corporate property at a discount relative to the property's FMV, the discount may be treated as a constructive dividend to the shareholder.

Shareholder Use of Corporate Property. If a shareholder uses corporate property (such as a hunting lodge, yacht, or airplane) without paying adequate consideration to the corporation, the fair rental value of such property (minus any amounts paid) may be treated as a constructive dividend to the shareholder.

ADDITIONAL COMMENT

For amounts incurred after 2017, no deduction is allowed for any activities involving entertainment, amusement, or recreation even if related to the taxpayer's trade or business.

STOCK DIVIDENDS AND STOCK RIGHTS

OBJECTIVE 4

Determine the tax consequences of stock dividends and the issuance of stock rights

TYPICAL MISCONCEPTION

Stock dividends generally are nontaxable as long as a shareholder's proportionate interest in the corporation does not increase. If a shareholder's stock interest increases, Sec. 305(b) causes the dividend to be taxable.

In 1919, the Supreme Court held in *Eisner v. Macomber* that a stock dividend is not income to the shareholder because it takes no property from the corporation and adds no property to the shareholder.¹⁴ Subsequently, Congress enacted the Revenue Act of 1921, which provides that stock dividends are nontaxable. Although this general rule still applies today, Congress has carved out several exceptions to prevent abuses.

Section 305(a) states, "Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock." Thus, a distribution of additional common stock with respect to a shareholder's pre-existing common stock holdings represents a nontaxable stock dividend. However, whenever a stock dividend changes or has the potential to change the shareholders' proportionate interest in the distributing corporation, the distribution will be taxable. Taxable stock distributions include those where

- ▶ Any shareholder can elect to receive either stock of the distributing corporation or other property (e.g., cash).
- ▶ Some shareholders receive property and other shareholders receive an increase in their proportionate interest in the distributing corporation's assets or E&P.

¹³ *Sterno Sales Corp. v. U.S.*, 15 AFTR 2d 979, 65-1 USTC ¶9419 (Ct. Cl., 1965).

¹⁴ *Eisner v. Myrtle H. Macomber*, 3 AFTR 3020, 1 USTC ¶32 (USSC, 1919).

- Some holders of common stock receive preferred stock and others receive additional common stock.
- The underlying stock is preferred unless the distribution involves a change in the conversion ratio of convertible preferred stock to take into account a common stock dividend or a common stock split.
- The distributed stock is convertible preferred, unless it can be established that the distribution will have no disproportionate effect.

The following example illustrates one such exception.

EXAMPLE C:4-18 ► Two shareholders, Al and Beth, each own 100 of the 200 outstanding shares of Peach Corporation stock. Because Al's marginal tax rate is high, he does not want to recognize any additional income in the current year. Beth has a low marginal tax rate and needs additional cash. Peach, whose current E&P is \$100,000, declares a dividend payable in stock or cash. Each taxpayer can receive one share of Peach stock (valued at \$100) or \$100 in cash for each share of Peach stock already owned. Al, who elects to receive stock, receives 100 additional Peach shares. Beth, who elects to receive cash, receives \$10,000. Beth's distribution is taxable as a dividend. Absent any exceptions to Sec. 305, Al's dividend would be nontaxable because it was paid in Peach stock. After the distribution, however, Al owns two-thirds of the outstanding shares of Peach stock, whereas before the distribution he owned only one-half of Peach's outstanding shares. In this case, an exception to the general rule of Sec. 305(a) applies so that Al is deemed to have received a taxable dividend equal to the value of the additional shares he received. Even if both shareholders elected to receive a stock dividend, this dividend would be taxable because each shareholder had the option to receive cash. In this example, Al and Beth each recognize \$10,000 of dividend income. Al's basis in his new shares is their \$10,000 FMV. His basis in his original shares is unchanged. Peach reduces its E&P by \$20,000, the amount of the taxable dividend to Al and Beth. ◀

NONTAXABLE STOCK DIVIDENDS

If a stock dividend is nontaxable, the basis of the stock with respect to which the distribution was made must be allocated between the old and new shares.¹⁵ The holding period for the new shares includes the holding period for the old shares.¹⁶

If the old and new shares are identical, the basis of each share is determined by dividing the basis of the old shares by the total number of shares held by the shareholder after the distribution.

EXAMPLE C:4-19 ► Barbara owns 1,000 shares of Axle Corporation common stock having a \$66,000 basis (\$66 per share). Barbara receives a nontaxable 10% common stock dividend and now owns 1,100 Axle common shares. Her basis in each share becomes \$60 ($\$66,000 \div 1,100$). ◀

If the old and new shares are not identical, the basis of the old shares is allocated according to the relative FMVs of the old and new shares on the distribution date.

EXAMPLE C:4-20 ► Mark owns 1,000 shares of Axle Corporation common stock having a \$60,000 basis. In a nontaxable distribution, Mark receives 50 shares of Axle preferred stock. At the time of the distribution, the FMV of the common stock is \$90,000 ($\$90 \times 1,000$ shares), and the FMV of the preferred stock is \$10,000 ($\200×50 shares). After the distribution, \$6,000 [$(\$10,000 \div \$100,000) \times \$60,000$] of the common stock basis is allocated to the preferred stock, and the basis of the common stock is reduced from \$60,000 to \$54,000. ◀

REAL-WORLD EXAMPLE

Tracking the effects of nontaxable dividends, stock splits, stock dividends, and stock rights distributions on the basis of a stock investment can be difficult and time consuming. A number of publishers offer capital change reporters that provide a complete history of these four types of events for publicly traded companies. These reporters greatly simplify the stock basis calculations.

NONTAXABLE STOCK RIGHTS

Under Sec. 305, a distribution of stock rights is nontaxable unless it changes, or has the potential to change, the shareholders' proportionate interest in the distributing corporation. The same Sec. 305(b) exceptions to the nontaxability of stock dividends also apply to distributions of stock rights.

If the value of the stock rights is less than 15% of the value of the stock with respect to which the rights were distributed (i.e., the underlying stock), the basis of the rights is zero unless the shareholder elects to allocate stock basis to the rights.¹⁷ If the taxpayer intends to sell the

¹⁵ Sec. 307(a) and Reg. Secs. 1.307-1 and -2.

¹⁶ Sec. 1223(5).

¹⁷ Sec. 307(b)(1).

rights, an allocation of his or her stock basis to the rights might be advisable so as to minimize the amount of gain recognized on the sale. The election to allocate stock basis to the rights must be made in a statement attached to the shareholder's return for the year in which the rights are received. The allocation must be based on the relative FMVs of the stock and the stock rights. The holding period for the rights includes the holding period for the underlying stock.¹⁸

EXAMPLE C:4-21 ▶ Linda owns 100 shares of Yale Corporation common stock having a \$27,000 basis and a \$50,000 FMV. Linda receives 100 nontaxable stock rights with a \$4,000 FMV. Because the FMV of the stock rights is less than 15% of the FMV of the underlying stock ($0.15 \times \$50,000 = \$7,500$), the basis of the stock rights is zero unless Linda elects to allocate the \$27,000 stock basis between the stock and the stock rights. If Linda makes the election, the basis of the rights is \$2,000 [$(\$4,000 \div \$54,000) \times \$27,000$], and the basis of the stock is \$25,000 ($\$27,000 - \$2,000$). ◀

If the value of the stock rights is 15% or more of the value of the underlying stock, the shareholder must allocate the basis of the underlying stock between the stock and the stock rights. This provision is mandatory, not elective.

EXAMPLE C:4-22 ▶ Kay owns 100 shares of Minor Corporation common stock having a \$14,000 basis and a \$30,000 FMV. Kay receives 100 stock rights with a total FMV of \$5,000. Because the FMV of the stock rights is at least 15% of the stock's FMV ($0.15 \times \$30,000 = \$4,500$), the \$14,000 basis must be allocated between the stock rights and the underlying stock based on their relative FMVs. The basis of the stock rights is \$2,000 [$(\$5,000 \div \$35,000) \times \$14,000$], and the basis of the underlying stock is \$12,000 [$(\$30,000 \div \$35,000) \times \$14,000$]. ◀

TYPICAL MISCONCEPTION

Taxpayers often get confused about what happens to a stock right. A stock right may be sold or exercised, which means the actual stock is acquired. If the rights are not sold or exercised, they eventually will lapse.

If the taxpayer sells the stock rights, he or she calculates gain or loss by subtracting the allocated basis of the rights (if any) from the sale price. A shareholder cannot claim a loss if the stock rights expire. If the stock rights do expire, the basis of the allocated rights is added back to the basis of the underlying stock. If the taxpayer exercises the rights before they expire, the basis of the allocated rights is added to the basis of the stock acquired through the exercise of the rights.¹⁹ The holding period for the stock acquired begins on the exercise date.²⁰

EXAMPLE C:4-23 ▶ In a nontaxable distribution, Jeff receives ten stock rights to which no stock basis is allocated. Each stock right entitles Jeff to acquire one share of Jackson stock for \$20. If Jeff exercises all ten rights, the Jackson stock acquired will have a \$200 ($10 \text{ rights} \times \20) basis. If instead Jeff sells the ten rights for \$30 each, he will recognize a gain of \$300 [$(\$30 \times 10 \text{ rights}) - 0 \text{ basis}$]. If the rights expire, Jeff may not claim a loss. ◀

EFFECT OF NONTAXABLE STOCK DIVIDENDS ON THE DISTRIBUTING CORPORATION

From a tax perspective, nontaxable distributions of stock and stock rights have no tax effect on the distributing corporation. The corporation recognizes no gain or loss and does not reduce its E&P balance.²¹

BOOK-TO-TAX ACCOUNTING COMPARISON

For financial accounting purposes, stock dividends reduce retained earnings. However, for tax purposes, nontaxable stock dividends have no effect on a corporation's E&P.

TAXABLE STOCK DIVIDENDS AND STOCK RIGHTS

If a distribution of stock or stock rights is taxable, the distribution amount equals the FMV of the stock or stock rights on the distribution date. The distribution is treated in the same way as any other property distribution. It is a dividend to the extent of the distributing corporation's E&P, and the recipient takes a FMV basis in the stock or stock rights received.²² The holding period for the stock or stock rights begins on the day after the distribution date. No adjustment is made to the basis of the underlying stock. The distributing corporation recognizes no gain or loss on the distribution,²³ and the corporation reduces its E&P by the FMV of the stock or stock rights on the distribution date.

Topic Review C:4-3 summarizes the tax consequences of a stock dividend.

¹⁸ Sec. 1223(5).

¹⁹ Reg. Sec. 1.307-1(b).

²⁰ Sec. 1223(6).

²¹ Secs. 311(a) and 312(d).

²² Reg. Sec. 1.301-1(h)(2)(i).

²³ Sec. 311(a). Gain may be recognized when the shareholder can elect to receive either appreciated property or stock or stock rights of the distributing corporation.

TOPIC REVIEW C:4-3

Tax Consequences of a Stock Dividend

SHAREHOLDERS:

1. A stock dividend is nontaxable except where (1) a shareholder can elect to receive other property in lieu of the stock dividend; (2) some shareholders receive property and other shareholders increase their proportionate equity interest; (3) some common shareholders receive preferred and others receive common stock; (4) the underlying stock is preferred stock, unless the conversion ratio, if any, is adjusted to account for a common stock split or dividend; or (5) the distributed stock is convertible preferred, and the distribution has a disproportionate effect.
2. If the stock dividend meets one of the exceptions to nontaxable treatment, the stock dividend is treated as a property distribution under Sec. 301, where the FMV of the distribution is a taxable dividend to the extent of the distributing corporation's E&P.
3. If the stock dividend is nontaxable, (1) the basis of the underlying stock (old shares) is allocated among the old and new shares according to relative FMVs, and (2) the holding period for the new shares includes the holding period for the old shares.
4. If the stock dividend is taxable, (1) the distributed stock takes a basis equal to its FMV on the distribution date, and (2) the holding period begins the after the distribution date.

DISTRIBUTING CORPORATION:

1. The distributing corporation recognizes no gain or loss on the stock dividend, whether it is nontaxable or taxable.
2. If the stock dividend is nontaxable, the distributing corporation does not reduce its E&P.
3. If the stock dividend is taxable, the distributing corporation reduces its E&P to the extent the distribution is treated as a taxable dividend.

STOCK REDEMPTIONS

OBJECTIVE 5

Decide whether a stock redemption should be treated as a sale or a dividend

A stock redemption is a corporation's acquiring its own stock in exchange for corporate property. This property may be cash, securities of other corporations, or any other consideration the corporation uses to acquire its own stock.²⁴ The corporation may cancel the acquired stock, retire it, or hold it as treasury stock.

A stock redemption may be desirable for the following reasons:

- A shareholder may want to withdraw from the corporate business and sell his or her equity interest. In such a case, the shareholder may prefer that the corporation, rather than an outsider, purchase his or her stock so that the remaining shareholders (who may be family members) retain complete control and ownership of the corporation after his or her withdrawal from the business.
- A shareholder may be required to sell stock to the corporation under the terms of a stock purchase agreement with the issuing corporation.
- A shareholder may want to reduce his or her equity interest in a corporation but may be unwilling or unable to sell stock to outsiders. For example, no market may exist for the shares, or sales to outsiders may be restricted.
- A shareholder may want to withdraw assets from a corporation before a sale of the corporation's business. A potential purchaser may not be interested in acquiring all the assets or be able to pay full value for all outstanding shares. A withdrawal of some assets by the seller in exchange for some of his or her shares allows the purchaser to acquire the remaining shares and business assets at a lower total price.
- After the death of a major shareholder, a corporation may agree to purchase the decedent's stock from either the estate or a beneficiary to provide sufficient funds to pay estate and inheritance taxes and funeral and administrative expenses.
- Management may believe that the corporation's stock is selling at a low price and that, to increase share value, the corporation should acquire some of its stock in the open market.

²⁴ Sec. 317.

Whatever the reason for the redemption, the shareholder must answer the following questions:

- ▶ What is the amount of the income, gain, or loss recognized as a result of the redemption, and what is its character?
- ▶ What basis does the shareholder take in any property received in exchange for his or her stock?
- ▶ When does the holding period for the distributed property begin?
- ▶ What basis does the shareholder take in any distributing corporation stock held after the redemption?

The distributing corporation must answer the following questions:

- ▶ What amount and character of gain or loss, if any, must the corporation recognize when it redeems stock with noncash property?
- ▶ What effect does the redemption have on the corporation's E&P?²⁵

TAX CONSEQUENCES OF THE REDEMPTION TO THE SHAREHOLDER

KEY POINT

As far as a shareholder is concerned, the basic issue in a stock redemption is whether the redemption is treated as a dividend or a sale.

As a general rule, when a shareholder sells or exchanges corporate stock, any gain or loss in the transaction is capital in character. In some cases, a redemption is treated as a stock sale. In other cases, it is treated as a dividend. The reason for this difference is that some redemptions resemble a stock sale to a third party, whereas others are essentially equivalent to a dividend. The following two examples illustrate the difference between a redemption resembling a dividend and a redemption resembling a sale. (The IRC refers to a "sale or exchange," but for simplicity in this chapter, we will use only the term "sale.")

EXAMPLE C:4-24 ▶ John owns all 100 outstanding shares of Tango Corporation stock. John's basis in his shares is \$50,000, and Tango's E&P is \$100,000. If Tango redeems 25 of John's shares for \$85,000, John still owns 100% of Tango stock. Because John's proportionate ownership of Tango has not changed as a result of the redemption, the redemption resembles a dividend (i.e., a distribution of corporate earnings). Accordingly, for tax purposes, John is deemed to have received an \$85,000 dividend. ◀

EXAMPLE C:4-25 ▶ Carol has owned three of the 1,000 outstanding shares of Water Corporation stock for two years. Her basis in the shares is \$1,000, and Water's E&P is \$100,000. If Water redeems all three of Carol's shares for \$5,000, Carol is essentially in the same position as a seller of stock to a third party. She has received \$5,000 for her stock and has no further ownership interest in the corporation. Thus, the redemption resembles a sale and is not essentially equivalent to a dividend. Accordingly, Carol recognizes a \$4,000 (\$5,000 – \$1,000) capital gain. ◀

Example C:4-24 is an extreme case involving a redemption that clearly should be treated as a dividend to the shareholder. Example C:4-25 also is an extreme case involving a redemption that clearly should be treated as a sale of stock by the shareholder. Many cases, however, fall between the two extremes, and the way the redemption should be treated is not immediately apparent. The problem for Congress and the courts has been how to distinguish redemptions that should be treated as sales from those that should be treated as dividends. Under current law, a redemption qualifies for sale treatment if it satisfies one of the following conditions:

- ▶ The redemption is substantially disproportionate.
- ▶ The redemption is a complete termination of the shareholder's interest.
- ▶ The redemption is not essentially equivalent to a dividend.
- ▶ The redemption involves a partial liquidation of the corporation in conjunction with its redeeming stock from a noncorporate shareholder.
- ▶ The redemption provides funds for an estate to pay death taxes.

If a redemption qualifies as a sale, the transaction is treated as though the shareholder sold stock to a third party. The shareholder recognizes gain or loss equal to the FMV of

²⁵ This discussion concerns the redemption of C corporation stock. Different rules apply to the redemption of S corporation stock.

the property received less the shareholder's adjusted basis in the stock surrendered. The gain or loss is capital in character if the stock is a capital asset in the hands of the shareholder. The shareholder's basis in any property received is its FMV. The holding period for the property begins on the day following the exchange date.

A redemption that does not satisfy any of the five conditions necessary for sale treatment is regarded as a property distribution under Sec. 301. Accordingly, the entire amount of the distribution is treated as a dividend to the extent of the distributing corporation's E&P.²⁶ The shareholder's stock basis is not taken into account in determining the dividend amount. Generally, this basis is added to the basis of any remaining shares owned by the shareholder. If all the shareholder's stock has been redeemed, the basis of the redeemed shares is added to the basis of shares owned by those individuals whose ownership is attributed to the shareholder under attribution rules described below.²⁷

EXAMPLE C:4-26 ►

Amy and Rose each own 50 of the 100 outstanding shares of stock in York Corporation, which reports \$100,000 of E&P. On May 10, York redeems 20 of Amy's shares with property worth \$25,000. Amy's adjusted basis in those shares is \$20,000. If the redemption satisfies one of the conditions necessary for sale treatment, Amy recognizes a capital gain of \$5,000 (\$25,000 – \$20,000). Her basis in the property received is its \$25,000 FMV, and its holding period begins on May 11. If the redemption does not satisfy any of the conditions necessary for sale treatment, Amy recognizes \$25,000 of dividend income. Her \$20,000 basis in the surrendered shares is added to the basis of her remaining 30 shares. ◀

ADDITIONAL COMMENT

Because capital gains and qualified dividends are taxed at the same rate, the difference in tax between exchange treatment and dividend treatment is primarily a function of the taxpayer's basis in the redeemed stock. Another difference is that dividends cannot offset capital losses.

Structuring a stock redemption as a sale offers two advantages. First, capital gains may be offset by capital losses. Second, in a sale, the basis of the shares redeemed reduces the amount of income recognized. By contrast, if a redemption is treated as a dividend, the basis of the shares redeemed does not reduce the dividend amount. Instead, the basis shifts to the shareholder's remaining stock, which reduces the gain (or increases the loss) recognized in a later sale of this stock.

Topic Review C:4-4 summarizes the tax consequences of stock redemptions to both the shareholder and the distributing corporation.

ATTRIBUTION RULES

Three of the five tests for determining how a redemption should be treated (i.e., as a sale or dividend) are based on stock ownership before and after the redemption. The tests measure the extent to which the shareholder's proportionate interest in the corporation has been reduced as a result of the exchange. In general, if the shareholder's proportionate interest has been substantially reduced, the redemption is treated as a sale. On the other hand, if this

TOPIC REVIEW C:4-4

Tax Consequences of Stock Redemptions

SHAREHOLDERS:

General Rule: The distribution amount received by a shareholder in exchange for his or her stock is treated as a dividend to the extent of the distributing corporation's E&P. The basis of the surrendered stock is added to the basis of the shareholder's remaining stock.

Sale Exception: If the redemption meets specific requirements, the distribution amount received by the shareholder is offset by the adjusted basis of the shares surrendered. The difference generally is treated as a capital gain or loss. No basis adjustment occurs.

DISTRIBUTING CORPORATION:

Gain/Loss Recognition: Under either the general rule or sale exception, the corporation recognizes gain (but not loss) as though it had sold distributed noncash property for its FMV immediately before the redemption.

Earnings and Profits Adjustment: For a redemption treated as a dividend, E&P is reduced in the same manner as for a regular dividend (e.g., by the amount of any money or the FMV of any property distributed). For a redemption treated as a sale, E&P is reduced by the lesser of (1) the redemption proceeds or (2) the portion of current and accumulated E&P attributable to the redeemed stock. Any distribution exceeding this second amount reduces the corporation's paid-in capital.

²⁶ Sec. 302(d).

²⁷ Reg. Sec. 1.302-2(c).

interest remains essentially the same or increases, the redemption is treated as a dividend (assuming sufficient E&P).

For the purpose of applying these tests, stock ownership is determined under the constructive ownership or attribution rules of Sec. 318.²⁸ According to these rules, a shareholder owns not only the shares he or she directly owns but also shares owned by his or her spouse, other immediate family members, and related entities. In addition, corporations, partnerships, trusts, and estates are considered to constructively own shares owned by their shareholders, partners, and beneficiaries.

The attribution rules prevent shareholders from taking advantage of favorable tax rules or avoiding unfavorable tax rules by transferring to family members or related entities stock that the shareholder previously owned. The proportionate stock ownership tests would be subject to abuse if only direct ownership were considered.

Section 318(a) sets forth four types of attribution rules: attribution among family members, attribution from entities, attribution to entities, and option attribution. These rules are discussed below.

ADDITIONAL COMMENT

The family attribution rules of Sec. 318 are not as inclusive as the family attribution rules of Sec. 267 (covered in Chapter C:3). For example, siblings and grandparents are not considered family members by Sec. 318 but are included under Sec. 267.

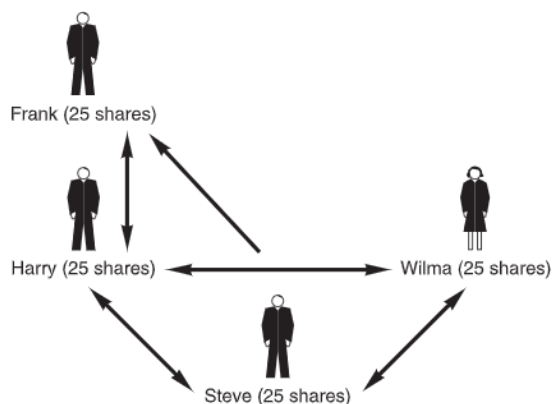
Family Attribution. Under the first set of rules, an individual is considered to own constructively all stock owned by or for his or her spouse, children, grandchildren, and parents. An individual is not considered to own stock owned by his or her brothers, sisters, or grandparents.

Once attributed to an individual under one set of attribution rules, stock ownership may not be reattributed to another individual under the same set of rules. Thus, stock ownership attributed to one family member under the family attribution rules may not be reattributed to a second family member under the same set of rules. However, once attributed to an individual under one set of attribution rules, stock ownership may be reattributed to another individual under a different set of attribution rules. For example, stock ownership attributed from a corporation to its shareholder under the corporate attribution rules may be reattributed to the shareholder's spouse under the family attribution rules.

EXAMPLE C:4-27

Harry; his wife, Wilma; their son, Steve; and Harry's father, Frank, each own 25 of the 100 outstanding shares of Strong Corporation stock. Under the family attribution rules, Harry is considered to own all 100 Strong shares (25 directly plus constructively the shares owned by Wilma, Steve, and Frank). Wilma is considered to own 75 shares (25 directly plus constructively the 50 shares owned by Harry and Steve). Ownership of Frank's shares is neither directly attributed to Wilma nor reattributed to Wilma through Harry. Steve is considered to own 75 shares (25 directly plus constructively the 50 shares owned by his parents Harry and Wilma). Ownership of Frank's shares is neither directly attributed to Steve nor reattributed to Steve through Harry. Frank is considered to own 75 shares (25 directly plus constructively the shares owned by Harry and Steve (his grandson)). Ownership of Wilma's shares is neither directly attributed to Frank nor reattributed to Frank through Harry.

The diagram below illustrates the constructive stock ownership of the four shareholders. The arrows indicate the direction(s) of ownership attribution.



²⁸ Sec. 302(c).

The table below shows each shareholder's direct and constructive stock ownership. Note that the total number of shares owned directly and constructively by all shareholders may exceed the total number of actual shares issued and outstanding.

<u>Shareholder</u>	<u>Direct Ownership</u>	<u>Shares Constructively Owned From:</u>				<u>Total</u>
		<u>Spouse</u>	<u>Child</u>	<u>Grandchild</u>	<u>Parent(s)</u>	
Frank	25		25	25		75
Harry	25	25	25		25	100
Wilma	25	25	25			75
Steve	25				50	75
	<u>100</u>					

Attribution from Entities. Under the second set of attribution rules, stock owned by or for a partnership is considered to be owned proportionately by the partners. Stock owned by or for an estate is considered to be owned proportionately by the beneficiaries. Stock owned by or for a trust is considered to be owned by the beneficiaries in proportion to their actuarial interests. Stock owned by or for a C corporation is considered to be owned proportionately only by shareholders owning (directly or indirectly) 50% or more of the corporation's stock value.²⁹

EXAMPLE C:4-28 ► Bill, who is married to Nancy, owns a 50% interest in Partnership A. Partnership A owns 40 of the 100 outstanding shares of Yellow Corporation stock, and Bill owns the remaining 60 shares. Under the entity attribution rules, Bill is considered to own 80 shares, 60 directly and 20 (0.50×40 shares) constructively. In addition, the stock ownership attributed to Bill under the entity attribution rules is reattributed to Nancy under the family attribution rules.

Attribution to Entities. Under the third set of attribution rules, all stock owned by or for a partner is considered to be constructively owned by the partnership. All stock owned by or for a beneficiary of an estate or a trust is considered to be constructively owned by the estate or trust. All stock owned by or for a shareholder who owns (directly or indirectly) 50% or more of a C corporation's stock value is considered to be constructively owned by the corporation.

Stock ownership attributed to a partnership, estate, trust, or corporation from a partner, beneficiary, or shareholder is not reattributed from the entity to another partner, beneficiary, or shareholder.

EXAMPLE C:4-29 ► Assume the same facts as in Example C:4-28. The partnership in which Bill is a partner is considered to own all 100 shares of Yellow stock (40 directly and 60 constructively through Bill). Bill's stock ownership attributed to the partnership cannot be reattributed from the partnership to Bill's partners.

Option Attribution. Under the last set of attribution rules, a person who holds an option to purchase stock is considered to own the underlying stock.

EXAMPLE C:4-30 ► John owns 25 of the 100 outstanding shares of Yard Corporation stock. He holds an option to acquire an additional 50 shares. John is considered to own 75 Yard shares (25 directly plus 50 constructively through the option).

SUBSTANTIALLY DISPROPORTIONATE REDEMPTIONS

Under Sec. 302(b)(2), if a stock redemption is substantially disproportionate with respect to a shareholder, it is treated as a sale and thus qualifies for capital gain as opposed to dividend treatment. A redemption is substantially disproportionate with respect to a shareholder if all the following conditions are met:

- After the redemption, the shareholder owns less than 50% of the total combined voting power of all classes of voting stock.

²⁹ For purposes of the attribution rules, S corporations are treated as partnerships, not corporations. Thus, attribution occurs to and from shareholders

owning less than 50% of the S corporation stock. Unless otherwise stated, all corporations in the examples are C corporations.

- After the redemption, the shareholder owns less than 80% of his or her percentage ownership of voting stock before the redemption.
- After the redemption, the shareholder owns less than 80% of his or her percentage ownership of common stock (whether voting or nonvoting) before the redemption.

TAX STRATEGY TIP

If possible, taxpayers should structure a redemption to meet the substantially disproportionate test rather than the subjective “not equivalent to a dividend” test (discussed on page C:4-23), thereby obtaining certainty of results.

These tests are applied mechanically to each shareholder’s ownership interest. The 50% test precludes shareholders from qualifying for capital gains treatment if they own a controlling interest in the distributing corporation after the redemption. The 80% tests define a degree of change in the shareholder’s proportionate interest that constitutes a substantial reduction in that interest. A redemption may be substantially disproportionate with respect to one shareholder but not another. If only one class of stock is outstanding, the second and third requirements are essentially the same.

EXAMPLE C:4-31 ►

Long Corporation has issued 400 shares of common stock and plans to redeem 100 of these shares. Before the redemption, Ann, Bob, Carl, and Dana (all unrelated) own 100 shares each. Long redeems 55 shares from Ann, 25 shares from Bob, and 20 shares from Carl. The following table illustrates ownership before and after the redemption.

ADDITIONAL COMMENT

In calculating the percentage of stock owned *after* a redemption note that the denominator used is the number of shares outstanding *after* the redemption.

Shareholder	Before Redemption		Shares Redeemed	After Redemption	
	No. of Shares Owned	Percentage of Ownership		No. of Shares Owned	Percentage of Ownership
	(1)	(1) ÷ 400	(2)	(1) – (2)	[(1) – (2)] ÷ 300
Ann	100	25%	55	45	15.00%
Bob	100	25%	25	75	25.00%
Carl	100	25%	20	80	26.67%
Dana	100	25%	—	100	33.33%
Total	400	100%	100	300	100.00%

The redemption is substantially disproportionate with respect to Ann because, after the redemption, she owns less than 50% of Long’s stock, and her stock ownership percentage (15%) is less than 80% of her stock ownership percentage before the redemption ($0.80 \times 25\% = 20\%$). The redemption is not substantially disproportionate with respect to Bob because the percentage reduction in his stock ownership is not less than 80% of his pre-redemption ownership percentage. In fact, Bob owns the same percentage of stock (25%) after the redemption as he did before the redemption (25%). The redemption also is not substantially disproportionate with respect to Carl because his stock ownership percentage increases from 25% to 26.67%. Thus, only the redemption of Ann’s shares is treated as a sale and qualifies for capital gains treatment. ◀

The constructive ownership rules of Sec. 318(a) apply in determining whether the shareholder has met the three conditions for a substantially disproportionate redemption.³⁰

EXAMPLE C:4-32 ►

Assume the same facts as in Example C:4-31 except that Ann is Bob’s mother. In this case, the redemption is not substantially disproportionate with respect to either Ann or Bob because, before the redemption, each directly and constructively owns 200 shares, or 50% of the Long stock, and after the redemption each directly and constructively owns 120 shares, or 40% of the stock. Although the 50% test is met, neither Ann nor Bob satisfies the 80% test. After the redemption each directly and constructively owns *exactly* 80% of the percentage owned before the redemption ($0.80 \times 50\% = 40\%$). ◀

COMPLETE TERMINATION OF THE SHAREHOLDER’S INTEREST

Under Sec. 302(b)(3), if a stock redemption completely terminates a shareholder’s interest in the corporation, the redemption also is treated as a sale. At first glance, this rule does not offer a route to sale treatment that is not already provided by the other Sec. 302 rules. If a corporation redeems all of a shareholder’s stock, in most cases the requirements for a substantially disproportionate redemption under Sec. 302(b)(2) would have been satisfied.

³⁰ Reg. Sec. 1.302-3(a).

However, the complete termination rule extends sale treatment to two redemptions not covered by the substantially disproportionate redemption rules:

- If a shareholder's interest in a corporation consists exclusively of nonvoting stock, a redemption of all the stock could not qualify as substantially disproportionate under Sec. 302(b)(2) because no reduction of voting power occurs. However, it could qualify as a complete termination of the shareholder's interest under Sec. 302(b)(3) because the interest need not consist of voting stock.
- If a shareholder owns some voting stock and the redemption terminates his or her entire interest in the corporation, the family attribution rules of Sec. 318(a)(1) may be waived. Consequently, the redemption could qualify for sale treatment even though other family members continue to own some or all of the corporation's stock.³¹

To have the family attribution rules waived, the shareholder must meet all of the following conditions:

- After the redemption, the shareholder must not retain any interest in the corporation except as a creditor. This restriction includes any interest as an officer, director, or employee.
- The shareholder must not acquire any such interest (other than by bequest or inheritance) for at least ten years from the date of the redemption.
- The shareholder must file a written agreement with the IRS that he or she will notify the IRS upon acquiring any prohibited interest.

The written agreement authorizes the IRS to assess additional taxes for the year of the redemption if the prohibited interest is acquired, even when the basic three-year limitations period has expired.

EXAMPLE C:4-33 ► Father and Son each own 50 of the 100 outstanding shares of Short Corporation stock. Short redeems all of Father's shares. Under the family attribution rules, Father is considered to own directly and constructively 100% of the Short stock both before and after the redemption. Thus, the redemption is not substantially disproportionate with respect to him. However, if Father agrees not to retain or acquire any interest in Short for ten years (except as a creditor, devisee, or heir), the family attribution rules may be waived. Consequently, the redemption could qualify as a complete termination of Father's interest and be treated as a sale. ◀

Waiver of the family attribution rules is not permitted in the following two situations involving related parties:

- Within the ten-year period ending on the distribution date, the distributee acquired, directly or indirectly, part or all of the redeemed stock from a person whose stock ownership would be attributable (at the time of the distribution) to the distributee under Sec. 318.
- Any person owns (at the time of the distribution) stock of the redeeming corporation the ownership of which is attributable to the distributee under Sec. 318, and such person acquired any stock in the redeeming corporation, directly or indirectly, from the distributee within the ten-year period ending on the distribution date.

The first restriction is aimed at an individual who transfers stock to a related party (e.g., family member or controlled entity) purportedly to enable the related party to invoke the complete termination provision so as to recognize a capital gain when the corporation redeems the transferred stock. The second restriction is aimed at an individual who transfers some of his or her stock to a related party purportedly to invoke the complete termination provision so as to recognize a capital gain when the corporation redeems his or her remaining stock. These prohibitions against waiving the family attribution rules do not apply if the shareholder transferred the stock more than ten years before the redemption or if the distributee can show that the acquisition or disposition of the stock did not have tax avoidance as one of its principal purposes. In the second situation above, the family attribution rules also can be waived if the corporation redeems as part of the same transaction stock previously transferred to the related party.

Note that only the family attribution rules can be waived. Entities may have the family attribution rules waived if both the entity and the individual whose stock is attributed to the entity agree not to acquire any prohibited interest in the corporation for at least ten years.

³¹ Section 302(c)(2) provides for the waiver of family attribution rules.

EXAMPLE C:4-34 ▶ Andrew created the A Trust, which owns 30% of Willow Corporation stock. Andrew's wife, Wanda, is the sole beneficiary of the trust. Their son, Steve, owns the remaining 70% of Willow stock. Willow redeems all of its stock owned by the A Trust. At first glance, the redemption does not qualify for sale treatment because the trust is deemed to own all the stock owned by Wanda, and Wanda is deemed to own all the stock owned by Steve. However, if both A Trust and Wanda agree not to acquire any interest in the corporation for ten years, the family attribution rules may be waived. Consequently, the redemption will be treated as a complete termination of the trust's interest in Willow and will be eligible for sale treatment. ◀

REDEMPTIONS NOT ESSENTIALLY EQUIVALENT TO A DIVIDEND

KEY POINT

Section 302(b)(1) has generally been interpreted to require that a shareholder incur a "meaningful reduction" of its stock interest. What constitutes a "meaningful reduction" remains unsettled.

Section 302(b)(1) provides that a redemption will be treated as a sale if it is not essentially equivalent to a dividend. The tax law sets forth no mechanical test for determining when a redemption is not essentially equivalent to a dividend. Instead, it implies that a determination should be based on the facts and circumstances of each case.³² Sec. 302(b)(1) does not provide a safe harbor similar to the rules for substantially disproportionate redemptions or redemptions that are a complete termination of a shareholder's interest. On the other hand, the provision prevents the redemption rules from being too restrictive, especially in the case of transactions involving preferred stock.

The Supreme Court's decision in *Maclin P. Davis* sets forth guidelines for determining when a redemption is not essentially equivalent to a dividend.³³ The Supreme Court held that (1) in this determination, a business purpose is irrelevant; (2) the Sec. 318 attribution rules must be applied to establish dividend equivalency; and (3) a redemption of part of a sole shareholder's stock is always essentially equivalent to a dividend. The Court further held that for Sec. 302(b)(1) purposes, there must be a "meaningful reduction" in the shareholder's proportionate interest in the corporation after taking into account the constructive ownership rules of Sec. 318(a). Despite this holding, the definition of "a meaningful reduction in interest" remains unclear.

Because of this lack of clarity, Sec. 302(b)(1) generally applies to a redemption of nonvoting preferred stock only where the shareholder does not own any common stock,³⁴ or to redemptions resulting in a substantial reduction in the shareholder's rights to vote and exercise control over the corporation, participate in earnings, and share in net assets upon liquidation. Generally, the IRS allows sale treatment if a controlling shareholder reduces his or her interest to a noncontrolling position,³⁵ or a noncontrolling shareholder further reduces his or her minority interest.³⁶ A shareholder does not qualify for sale treatment if he or she maintains control both before and after the redemption,³⁷ or if he or she assumes a controlling position.

EXAMPLE C:4-35 ▶ Four unrelated individuals own all of Thyme Corporation's single class of stock as follows: Alan, 27%; Betty, 24.33%; Clem, 24.33%; and David, 24.33%. Thyme redeems some of Alan's stock holdings, resulting in a reduction of Alan's interest to 22.27%. After the redemption of Alan's stock, Betty, Clem, and David each own 25.91% of Thyme stock. The redemption of Alan's stock does not qualify as substantially disproportionate because Alan's interest is not reduced below 21.6% ($0.80 \times 27\% = 21.6\%$). Nor does the redemption qualify as a complete termination of Alan's interest because Alan still owns Thyme shares. However, the redemption will be treated as a sale under Sec. 302(b)(1) because the transaction results in a meaningful reduction of Alan's noncontrolling interest in Thyme. See Rev. Rul. 76-364 cited in footnote 36. ◀

PARTIAL LIQUIDATIONS

Under Sec. 302(b)(4), a redemption of a noncorporate shareholder's stock qualifies for sale treatment if the redemption is in partial liquidation of the corporation. A partial liquidation occurs when a corporation discontinues one line of business, distributes assets used in that business to its shareholders, and continues at least one other line of business.³⁸ A distribution

³² Reg. Sec. 1.302-2(b).

³³ *U.S. v. Maclin P. Davis*, 25 AFTR 2d 70-827, 70-1 USTC ¶9289 (USSC, 1970).

³⁴ Reg. Sec. 1.302-2(a).

³⁵ In Rev. Rul. 75-502, 1975-2 C.B. 111, a reduction in stock ownership from 57% to 50% where the shareholder no longer had control was considered a meaningful reduction in interest.

³⁶ In Rev. Rul. 76-364, 1976-2 C.B. 91, a reduction in stock ownership from 27% to 22.27% was considered a meaningful reduction in interest. In this ruling, the IRS found it significant that, before the redemption, the redeemed shareholder acting in concert with only one other shareholder could exert

control ($27\% + 24.33\% > 50\%$) but could not do so after the redemption ($22.27\% + 25.91\% \not> 50\%$).

³⁷ See *Jack Paparo*, 71 T.C. 692 (1979), where reductions in stock ownership from 100% to 81.17% and from 100% to 74.15% were not considered meaningful reductions in interest.

³⁸ A partial liquidation also can occur when a corporation sells one line of business, distributes the sales proceeds (after paying taxes on any gain from the sale), and continues at least one other line of business. See Rev. Rul. 79-275, 1979-2 C.B. 137.

in partial liquidation qualifies for sale treatment if it is not essentially equivalent to a dividend. The distribution must be made within the tax year in which a plan of partial liquidation has been adopted or within the succeeding tax year.

Determination Made at the Corporate Level. For purposes of Sec. 302(b)(4), whether a distribution is not essentially equivalent to a dividend is determined at the corporate level.³⁹ The distribution must result from a bona fide contraction of the corporate business. In relevant Treasury Regulations and revenue rulings, the government provides guidance as to what constitutes a bona fide business contraction. Examples include

- The distribution of insurance proceeds received as a result of a fire that destroys part of a business.⁴⁰
- Termination of a contract representing 95% of a domestic corporation's gross income.⁴¹
- Change in a corporation's business from a full-line department store to a discount apparel store, which results in the elimination of certain units; the elimination of most forms of credit; and a reduction in inventory, floor space, and employees.⁴²

Safe Harbor Rule. Under Sec. 302(e)(2), a distribution satisfies the not-essentially-equivalent-to-a-dividend requirement and qualifies as a partial liquidation if

- The distribution is attributable to the distributing corporation's ceasing to conduct a qualified trade or business, or consists of the assets of a qualified trade or business; and
- Immediately after the distribution, the distributing corporation is engaged in the active conduct of at least one qualified trade or business.

A qualified trade or business is any trade or business that

- Has been actively conducted throughout the five-year period ending on the date of the redemption, and
- Was not acquired by the corporation within such five-year period in a partially or wholly taxable transaction.

The definition of an active trade or business is the same as that used for Sec. 355 (corporate division) purposes, as discussed in Chapter C:7.

EXAMPLE C:4-36 ► Sage Corporation has manufactured hats and gloves for the past five years. In the current year, Sage discontinues hat manufacturing, sells all of its hat manufacturing machinery, and distributes the proceeds to its shareholders in redemption of some of their Sage shares. The corporation continues glove manufacturing. The distribution is pursuant to a partial liquidation and thus qualifies for sale treatment. ◀

Tax Consequences of a Partial Liquidation to the Shareholders. If a distribution is in partial liquidation of the corporation, a noncorporate shareholder treats the redemption of his or her stock as a sale, whether or not the distribution is pro rata. In contrast, a corporate shareholder treats the redemption distribution as a dividend unless the corporation meets one of the other tests for sale treatment (i.e., Sec. 302(b)(1)-(3) or Sec. 303). For a corporate shareholder, dividend treatment may be more advantageous than sale treatment because a corporation receives no preferential tax rate on capital gains, but may be eligible for a 50%, 65%, or 100% dividends-received deduction. In determining whether stock is owned by a corporate or noncorporate shareholder, stock held by a partnership, trust, or estate is considered to be held proportionately by its partners or beneficiaries.

EXAMPLE C:4-37 ► Assume the same facts as in Example C:4-36 except Sage Corporation is owned by Ted and Jolly Corporation. Each shareholder owns 50 shares of Sage stock with a \$20,000 basis and has owned the stock since Sage's inception. Sage reports \$100,000 of current and accumulated E&P. Sage distributes \$18,000 to each shareholder in redemption of ten shares of stock worth \$18,000. Because the redemption involves a partial liquidation, Ted treats

³⁹ Sec. 302(e)(1)(A).

⁴⁰ Reg. Sec. 1.346-1.

⁴¹ Rev. Rul. 75-3, 1975-1 C.B. 108.

⁴² Rev. Rul. 74-296, 1974-1 C.B. 80.

the transaction as a sale and recognizes a capital gain of \$14,000 (\$18,000 – \$4,000). Jolly, however, cannot treat the transaction as a sale because Jolly is a corporate shareholder and thus must recognize \$18,000 of dividend income. On the other hand, Jolly is eligible for a \$11,700 ($0.65 \times \$18,000$) dividends-received deduction. Jolly's \$4,000 basis in the ten redeemed shares is added to the basis of its 40 remaining shares, resulting in a \$20,000 basis in those shares. ◀

STOP & THINK

Question: Why is a distribution in partial liquidation of a corporation treated as a sale by its noncorporate shareholders and as a dividend by its corporate shareholders?

Solution: The different tax treatment probably reflects different tax advantages. Noncorporate shareholders benefit most from sale treatment because they can offset their stock basis against any amount realized in the distribution. Corporate shareholders benefit most from dividend treatment because they can take the dividends-received deduction, thereby reducing the dividend tax burden. These disparate advantages stem from the different tax status of corporations, other entities, and individuals.

TAX STRATEGY TIP

An estate with liquidity problems owing to large holdings of a closely held business also may want to consider installment payment of the estate tax under Sec. 6166. See Chapter C:13 for further details.

REDEMPTIONS TO PAY DEATH TAXES

If corporate stock represents a substantial portion of a decedent's gross estate, a redemption of the stock from the estate or its beneficiaries may be eligible for sale treatment under Sec. 303. This IRC section helps shareholders who inherit stock in a closely held corporation pay estate and inheritance taxes and funeral and administrative expenses. If the stock is not readily marketable, a stock redemption may be the only way to provide the estate and its beneficiaries with sufficient liquidity to defray the costs of estate administration. Under the substantially disproportionate or complete termination rules, ownership attribution would disqualify the redemption from sale treatment. Consequently, the redemption would be treated as a dividend. Under Sec. 303, ownership attribution does not apply to the portion of a stock redemption that meets certain requirements.

Section 303 provides that a redemption of stock that was included in a decedent's gross estate is treated as a stock sale by the shareholder (i.e., either the estate or the beneficiary of the estate) if the following conditions are met:

1. The value of the redeeming corporation's stock included in the decedent's gross estate is more than 35% of the adjusted gross estate. The adjusted gross estate consists of the FMV of all property on the date of the decedent's death less allowable deductions for funeral and administrative expenses, claims against the estate, debts, and casualty and other losses.

EXAMPLE C:4-38

▶ A decedent's gross estate, valued at \$20 million, includes \$6 million in cash and Pepper Corporation stock worth \$14 million. Funeral and other deductible estate expenses amount to \$2 million. Thus, the decedent's adjusted gross estate is \$18 million (\$20,000,000 – \$2,000,000). Because the \$14 million value of the Pepper stock included in the gross estate exceeds 35% of the adjusted gross estate ($\$6.3 \text{ million} = 0.35 \times \$18,000,000$), a redemption of this stock qualifies for sale treatment under Sec. 303. ◀

2. The maximum amount of the redemption distribution that can qualify for sale treatment is the sum of all federal and state estate and inheritance taxes, plus any interest due on those taxes, and all funeral and administrative expenses allowable as deductions in computing the federal estate tax. The redemption must be of stock held by the estate or by the decedent's heirs who are liable for estate taxes and other administrative expenses.

3. Section 303 applies to a redemption distribution only to the extent the shareholder's interest in the estate is reduced by the payment of death taxes and funeral and administration expenses. The maximum distribution eligible for sale treatment is the amount of estate taxes and expenses the shareholder is obligated to bear.

EXAMPLE C:4-39

▶ Assume the same facts as in Example C:4-38 except that, before the decedent's death, all the stock was gifted to the decedent's son, Sam. The remaining assets were bequeathed to the

decedent's wife, Wilma, who as beneficiary is indirectly liable for all estate taxes and administrative expenses. Section 303 sale treatment is not available to Sam because he is not liable for estate taxes or administrative expenses. If instead \$4 million in nonstock assets had been gifted to Wilma before the decedent's death, and the remaining assets bequeathed to Sam, Sam as beneficiary would be indirectly liable for all estate taxes and administrative expenses. In such case, he could use Sec. 303 to obtain sale treatment for the redemption of enough of his stock to pay estate taxes and administrative expenses. ◀

4. Section 303 applies only to distributions within certain time limits.

a. In general, the redemption must occur not later than 90 days after the expiration of the period for assessing the federal estate tax. Because the limitations period for the federal estate tax expires three years after the estate tax return is due and because the return is due nine months after the date of death, the redemption generally must occur within four years after the date of death.

b. If a petition for redetermination of an estate tax deficiency is filed with the Tax Court, the distribution period is extended to 60 days after the Tax Court's decision becomes final.

c. If the taxpayer made a valid election under Sec. 6166 to defer paying of federal estate taxes under an installment plan, the distribution period is extended to the time the installment payments are due.

5. The stock of two or more corporations may be aggregated to meet the 35% threshold, provided that 20% or more of the value of each corporation's outstanding stock is included in the gross estate.

EXAMPLE C:4-40 ►

A decedent's gross estate, valued at \$23.6 million, includes 80% of the stock in Curry Corporation, valued at \$5.2 million, and 90% of the stock in Brodie Corporation, valued at \$2.8 million. Deductible funeral and administrative expenses amount to \$3.6 million. Thus, the decedent's adjusted gross estate is \$20 million (\$23,600,000 – \$3,600,000). Although the value of neither the Curry stock nor the Brodie stock exceeds 35% of the \$20 million adjusted gross estate, the \$8 million (\$5,200,000 + \$2,800,000) total value of both corporations' stock does exceed 35% of the adjusted gross estate (\$7 million = $0.35 \times \$20,000,000$). Therefore, a redemption of sufficient Curry stock and/or Brodie stock to pay estate taxes and funeral and administrative expenses qualifies for sale treatment under Sec. 303. ◀

Although the legislative intent behind Sec. 303 is to provide liquidity for the payment of estate taxes and administrative expenses where a significant portion of the estate consists of stock in a closely held corporation, a redemption can qualify for Sec. 303 sale treatment even where the estate includes sufficient liquid assets to pay estate taxes and defray administrative costs. The redemption proceeds need not be used for these purposes.

The advantage of a Sec. 303 redemption is that the redeeming shareholder usually realizes little or no capital gain because his or her basis in the redeemed stock is the stock's FMV on date of the decedent's death (or an alternate valuation date, if applicable). If the redemption does *not* qualify as a sale, the redeeming shareholder recognizes dividend income equal to the distribution proceeds received in redemption of the stock.

EXAMPLE C:4-41 ►

SELF-STUDY QUESTION

How much gain is the redeeming shareholder likely to recognize in a qualifying Sec. 303 redemption?

ANSWER

Probably little or none. The basis in the redeemed stock equals its FMV at the decedent's date of death (or an alternate valuation date). The recognized gain generally is only the post-death appreciation.

Chili Corporation pays \$105,000 to redeem 100 shares of stock from Art, who inherited the stock from his father, Fred. The stock's FMV on Fred's date of death was \$100,000. Chili reports an E&P balance of \$500,000. If the redemption qualifies for sale treatment under Sec. 303, Art recognizes a \$5,000 (\$105,000 – \$100,000) capital gain. On the other hand, if the redemption does not qualify for sale treatment under Sec. 303 or one of the other redemption provisions, Art recognizes \$105,000 of dividend income. Although both the capital gain and the dividend income are subject to the applicable capital gains tax rate, the dividend amount significantly exceeds the capital gain amount. ◀

EFFECT OF REDEMPTIONS ON THE DISTRIBUTING CORPORATION

As in the case of property distributions that are not in redemption of stock, two questions relating to property distributions in redemption of stock must be answered:

- ▶ What amount and character of gain or loss must the distributing corporation recognize?
- ▶ What effect does the distribution have on the corporation's E&P?

Each of these questions is addressed below.

Corporate Gain or Loss on Property Distributions. The rules for gain or loss recognition for a corporation that distributes property in redemption of its stock are the same as the Sec. 311 rules pertaining to property distributions not in redemption of stock.

- ▶ The corporation recognizes gain when it redeems its stock by distributing property that has appreciated in value. The character of the gain depends on the character of the property distributed.
- ▶ The corporation recognizes no loss when it redeems its stock by distributing property that has declined in value.

Effect of Redemptions on E&P. A stock redemption affects a corporation's E&P in two ways. First, if the corporation distributes appreciated property, the excess of the property's FMV over its E&P adjusted basis increases the balance in the E&P account. Second, if the corporation distributes cash, or other property, the corporation's E&P balance is reduced accordingly. The extent of the reduction depends on whether the shareholder treats the redemption as a sale or a dividend.

If the redemption is treated as a dividend, the corporation reduces its E&P by the amount of any cash, the principal amount of any obligations, and the greater of the adjusted basis or FMV of any other property distributed, in the same way as it does for a property distribution not in redemption of stock.

If the redemption is treated as a sale, the corporation reduces its E&P by the portion of its current and accumulated E&P attributable to the redeemed stock. In other words, E&P is reduced by the percentage of the total outstanding shares redeemed, not to exceed the actual distribution amount. Any distribution amount exceeding this percentage reduces the corporation's tax basis paid-in capital.⁴³ Ordinary dividend amounts are subtracted from current E&P before the subtraction of stock redemption amounts. No such sequencing exists for accumulated E&P. Both ordinary dividend distributions and redemption distributions reduce accumulated E&P in chronological order.

ADDITIONAL COMMENT

The rule also could be stated as E&P is reduced by the lesser of (1) the redemption proceeds or (2) the pro rata share of E&P attributable to the redeemed stock

EXAMPLE C:4-42

▶ Apex Corporation has 100 shares of stock outstanding, 30 of which are owned by Mona. On December 31, Apex pays \$36,000 to redeem all 30 of Mona's shares in a redemption qualifying as a sale. At the time of the redemption, Apex has \$60,000 in paid-in capital and \$40,000 of E&P. Because Apex redeemed 30% of its outstanding stock, the distribution reduces Apex's E&P by \$12,000 ($0.30 \times \$40,000$). The remaining \$24,000 ($\$36,000 - \$12,000$) reduces Apex's tax basis paid-in capital to \$36,000 ($\$60,000 - \$24,000$).⁴⁴ ◀

PREFERRED STOCK BAILOUTS

OBJECTIVE 6

Explain the tax treatment of preferred stock bailouts

The stock redemption rules permit sale treatment in certain situations and require dividend treatment in all others. Generally, taxpayers prefer sale treatment for two reasons. First, sale treatment allows taxpayers to offset their stock basis against the distribution proceeds. Second, gain on a stock sale generally is long-term and capital in character. This gain may be entirely offset by the taxpayer's capital losses and thus not be taxed at all. With these results in mind, taxpayers have attempted various schemes to obtain sale rather than dividend treatment.

⁴³ Sec. 312(n)(7). This adjustment to paid-in capital might be necessary for companies that maintain tax basis balance sheets, for example, to determine book-tax differences in complying with ASC 740, Income Taxes, which is the FASB Accounting Standards Codification for SFAS No. 109.

⁴⁴ Distributions during the year require a different calculation, which is beyond the scope of this text.

ADDITIONAL COMMENT

When the term *bailout* is used in the corporate context, it generally refers to a scheme that allows a corporation to make a dividend distribution that for tax purposes is treated as a sale of a capital asset.

One such method is a preferred stock bailout. Prior to Congress' enacting anti-tax avoidance measures, a preferred stock bailout typically proceeded as follows:

1. A corporation issued a nontaxable dividend of nonvoting preferred stock to its common shareholders. Under the rules relating to nontaxable stock dividends, a portion of the common stock basis was allocated to the preferred stock. Its holding period included the holding period for the common stock.
2. The recipient shareholder then sold the preferred stock at its FMV to an unrelated third party. As a result of the sale, the shareholder recognized a capital gain equal to the difference between the preferred stock's sale price and its allocated basis.
3. Next, the corporation redeemed the preferred stock from the third-party (usually at a small premium to reward the third party for his or her cooperation in the scheme).
4. As an alternative to steps 2 and 3, the corporation redeemed the preferred stock directly from the shareholder.

As a result of this preferred stock bailout, the shareholder extracted the corporation's E&P and converted what otherwise would have been a dividend into a long-term capital gain without changing his or her equity position. To deter such tax avoidance, Congress enacted Sec. 306, which "taints" certain stock (usually preferred stock) when distributed to a shareholder in a nontaxable stock dividend. Section 306 treats the distribution proceeds as a dividend if the corporation redeems the tainted stock directly from the shareholder and treats the amount realized as ordinary income if the shareholder sells the stock to a third party. Either way, Sec. 306 prevents shareholders from using a preferred stock bailout to convert ordinary income into capital gain.

Recent tax acts, however, have taken the "sting" out of Sec. 306 by taxing dividends at the same rate as capital gains. Thus, both the dividend recognized on a direct redemption of Sec. 306 stock and the "deemed" dividend recognized on a third-party sale of the stock are taxed at the applicable capital gains rate. Nevertheless, the Sec. 306 taint is still disadvantageous because, even though subject to the preferential capital gains tax rate, dividends cannot offset capital losses as can "real" capital gains. Also, if Sec. 306 recasts the redemption as a dividend, the shareholder is taxed on the entire amount of distribution proceeds rather than just the net gain.

SEC. 306 STOCK DEFINED

Section 306 stock is defined as follows:⁴⁵

- Stock (other than common issued with respect to common) received in a nontaxable stock dividend
- Stock (other than common) received in a nontaxable corporate reorganization or corporate division if the effect of the transaction was substantially the same as the receipt of a stock dividend, or if the stock was received in exchange for Sec. 306 stock
- Stock that has a basis determined by reference to the basis of Sec. 306 stock (i.e., a substituted or transferred basis)
- Stock (other than common) acquired in an exchange to which Sec. 351 applies if the receipt of money (in lieu of the stock) would have been treated as a dividend

Preferred stock issued by a corporation with no current or accumulated E&P in the year the stock is issued is not Sec. 306 stock. Also, inherited stock is not Sec. 306 stock because the basis of such stock is its FMV on the date of the decedent's death (or alternate valuation date) and, therefore, is not determined by reference to the decedent's basis.⁴⁶

DISPOSITIONS OF SEC. 306 STOCK

If a shareholder sells or otherwise disposes of Sec. 306 stock (except in a redemption), the amount realized is treated as a deemed dividend to the extent the shareholder would have recognized a dividend at the time of the distribution had cash equal to the stock's FMV, instead of stock, been distributed. The shareholder's deemed dividend is measured by

TYPICAL MISCONCEPTION

Although the amount of deemed dividend income recognized on a sale of Sec. 306 stock is measured by the E&P existing in the year the Sec. 306 stock was distributed, the E&P of the distributing corporation is not reduced by the amount of the deemed dividend.

⁴⁵ Sec. 306(c).

⁴⁶ Reg. Sec. 1.306-3(e).

reference to the corporation's E&P in the year the Sec. 306 stock was issued, although the corporation does not reduce its E&P upon the sale. Any additional amount received for the Sec. 306 stock generally is treated as a return of capital. If the additional amount exceeds the shareholder's basis in the Sec. 306 stock, the excess is treated as a capital gain. If the additional amount is less than the shareholder's basis, the unrecovered basis is not treated as a loss. Rather, it is added back to the shareholder's basis in his or her common shares.

EXAMPLE C:4-43 ▶ Carlos owns all 100 outstanding shares of Adobe Corporation common stock. His basis in the shares is \$100,000. Adobe, which has \$150,000 of E&P, distributes 50 shares of nonvoting preferred to Carlos in a nontaxable stock dividend. On the distribution date, the FMV of the preferred stock is \$50,000, and the FMV of the common stock is \$200,000. Carlos must allocate his \$100,000 common stock basis between the common and preferred shares according to their relative FMVs as follows:

	<u>FMV</u>	<u>Basis</u>
Common stock	\$200,000	\$ 80,000 ^a
Preferred stock	50,000	20,000 ^b
Total	<u>\$250,000</u>	<u>\$100,000</u>
^a $\frac{\$200,000}{\$250,000} \times \$100,000$	^b $\frac{\$50,000}{\$250,000} \times \$100,000$	

Carlos subsequently sells the preferred stock to Dillon for \$50,000. The \$50,000 sales proceeds are treated as a deemed dividend because Adobe's E&P in the year the corporation distributed the preferred stock exceeded the stock's FMV. Carlos's \$20,000 basis in the preferred shares is added back to his basis in the common shares, thereby restoring his common stock basis to \$100,000. If instead Carlos sells the preferred stock for \$80,000, he recognizes a \$50,000 deemed dividend, a \$20,000 return of capital, and a \$10,000 capital gain computed as follows:

Sales proceeds	\$80,000
Minus: Deemed dividend income ^a	<u>(50,000)</u>
Remaining sales proceeds	\$30,000
Minus: Return of capital ^b	<u>(20,000)</u>
Capital gain ^c	<u>\$10,000</u>

^aSmaller of E&P in year stock was issued or stock's FMV on the distribution date.

^bSmaller of remaining sales proceeds or stock adjusted basis.

^cSales proceeds received in excess of stock adjusted basis.

KEY POINT

The amount realized in a redemption of Sec. 306 stock is a dividend to the extent of E&P existing in the year of redemption. Unlike a sale of Sec. 306 stock, E&P is reduced as a result of a redemption.

REDEMPTIONS OF SEC. 306 STOCK

If the issuing corporation redeems Sec. 306 stock, the shareholder's total amount realized is treated as a distribution to which the Sec. 301 dividend rules apply. Specifically, it is treated as a dividend to the extent of the redeeming corporation's current and accumulated E&P measured *in the year of the redemption* and reduces corporate E&P accordingly. Amounts received in excess of the corporation's E&P are treated as a recovery of the shareholder's basis in his or her Sec. 306 stock, and then as a capital gain to the extent such amounts exceed basis. If all or a portion of the shareholder's basis in the redeemed stock is not recovered, the unrecovered amount increases the basis of the shareholder's common stock.

EXAMPLE C:4-44 ▶ Don owns all 100 shares of Brigham Corporation common stock having a \$300,000 adjusted basis. Four years ago, Brigham issued 50 shares of preferred stock to Don. On the distribution date, the FMVs of the preferred stock and common stock were \$100,000 and \$400,000, respectively. Brigham's E&P in the distribution year was \$200,000. Don's allocated basis in the preferred stock was \$60,000 $\{[\$100,000 \div (\$100,000 + \$400,000)] \times \$300,000\}$. The basis of Don's common stock was reduced to \$240,000 $(\$300,000 - \$60,000)$ as a result of this allocation. On January 2 of the current year, Brigham redeems the preferred shares for \$250,000. In the redemption year, Brigham's total E&P is \$400,000. Thus, Don recognizes dividend income of \$250,000. If Brigham's total E&P instead had been \$200,000 in the redemption year, Don would have recognized \$200,000 of dividend income and a \$50,000 nontaxable return of capital. Because Don's

basis in his preferred stock is \$60,000, the \$10,000 unrecovered basis would have increased his basis in the common stock to \$250,000 (\$240,000 + \$10,000). ◀

EXCEPTIONS TO SEC. 306 TREATMENT

Section 306 does not apply in the following situations.

- ▶ A shareholder sells all of his or her common and preferred stock, thereby completely terminating his or her interest in the issuing corporation.
- ▶ The corporation redeems all the shareholder's common and preferred stock, completely terminating the shareholder's interest in the corporation.
- ▶ The corporation redeems an individual shareholder's stock in a partial liquidation qualifying for sale treatment under Sec. 302(b)(4).
- ▶ A shareholder disposes of Sec. 306 stock in a way that triggers no gain or loss recognition (e.g., a gift). Although the donor recognizes no income when he or she disposes of Sec. 306 stock by gift, the stock retains its taint and remains Sec. 306 stock in the donee's hands. On the other hand, because heirs and devisees take a FMV basis in estate assets, the taint disappears when they inherit the stock.
- ▶ Section 306 does not apply if the taxpayer demonstrates to the IRS's satisfaction that the distribution and subsequent disposition of Sec. 306 stock did not have tax avoidance as a principal purpose.

TAX STRATEGY TIP

A taxpayer owning a portfolio of stock that includes Sec. 306 stock may want to retain the Sec. 306 stock and pass it on to his or her heirs, thereby eliminating the Sec. 306 taint. Market conditions, however, will dictate whether retaining the stock is a good investment strategy.

STOCK REDEMPTIONS BY RELATED CORPORATIONS

OBJECTIVE 7

Assess the applicability and tax consequences of Sec. 304 to stock sales

If a shareholder sells stock in one corporation (the issuing corporation) to a second corporation (the acquiring corporation), the shareholder usually recognizes a capital gain or loss. However, if the shareholder controls both corporations, he or she may have to recognize dividend income because the net result may resemble a dividend more than a sale.

To prevent shareholders from using two corporations they commonly control to convert what is essentially a dividend into a capital gain, Sec. 304 requires that a sale of stock of one controlled corporation to a second controlled corporation be treated as a stock redemption. If the redemption meets the requirements for sale treatment (e.g., if the redemption is substantially disproportionate), the transaction will be treated as a sale. Otherwise, the redemption will be treated as a dividend to the extent of E&P. As in the case of Sec. 306 preferred stock bailouts, because individuals pay the applicable capital gains tax rate on qualified dividends and capital gains, Sec. 304 does not deliver a major "sting." Nevertheless, when it does apply, shareholders may have to recognize dividend income rather than capital gain and cannot offset either stock basis or capital losses against this dividend income.

Section 304 applies to two types of sales. The first is a sale of stock involving two brother-sister corporations. The second is a sale of a parent corporation's stock to one of its subsidiaries. The following sections define brother-sister and parent-subsidiary corporations and explain how Sec. 304 applies to each group.

BROTHER-SISTER CORPORATIONS

Two corporations are called brother-sister corporations when one or more shareholders control each of the corporations and a parent-subsidiary relationship does not exist. Control means ownership of at least 50% of the voting power or 50% of the total value of all the corporation's stock. The shareholder(s) who acquired such ownership are called controlling shareholders. If a controlling shareholder (or shareholders) transfers stock in one corporation to the other corporation in exchange for property, the exchange must be recast as a redemption.

ADDITIONAL COMMENT

The definition of brother-sister corporations for Sec. 304 differs from the definition for controlled groups discussed in Chapter C:3.

To determine whether the redemption is treated as a sale or a dividend, reference is made to the shareholder's stock ownership in the issuing corporation. For purposes of this determination, the attribution rules of Sec. 318(a) apply.⁴⁷

Redemption Treated as a Distribution. If the redemption does not qualify for sale treatment, it is treated as a dividend paid first by the acquiring corporation to the extent of its E&P, and then by the issuing corporation to the extent of its E&P. The shareholder's basis in the issuing corporation's stock sold is added to his or her basis in the acquiring corporation's stock. The acquiring corporation takes the same basis in the issuing corporation's stock as the shareholder's.

EXAMPLE C:4-45 ▶ Bert owns 60 of the 100 outstanding shares of First Corporation stock and 60 of the 100 outstanding shares of Second Corporation stock (see Figure C:4-1). First and Second have \$50,000 and \$20,000 of E&P, respectively. Bert sells to Second for \$20,000 20 shares of First stock with an adjusted basis of \$10,000. Because Bert owns at least 50% of each corporation's stock, Bert is deemed to control both First and Second, and Sec. 304 governs the transaction. Accordingly, the sale is recast as a redemption. To determine whether the redemption qualifies for sale treatment, reference is made to Bert's percentage ownership of First stock. Before the redemption, Bert owned 60% of First stock. After the redemption, Bert owns 52% of First stock (40 shares directly and 12 $[0.60 \times 20]$ shares constructively through Second). Because the redemption satisfies none of the Sec. 302 tests for sale treatment, Sec. 301 governs the outcome. Under this provision, the entire distribution is treated as a dividend because it does not exceed First's and Second's total E&P of \$70,000. All \$20,000 of the distribution is deemed to have been made out of Second's E&P because it is sufficient to cover the distribution amount. Second's basis in the First stock is \$10,000, the same as Bert's. Bert increases his basis in Second stock by \$10,000, his basis in the First stock he is deemed to have contributed to Second.

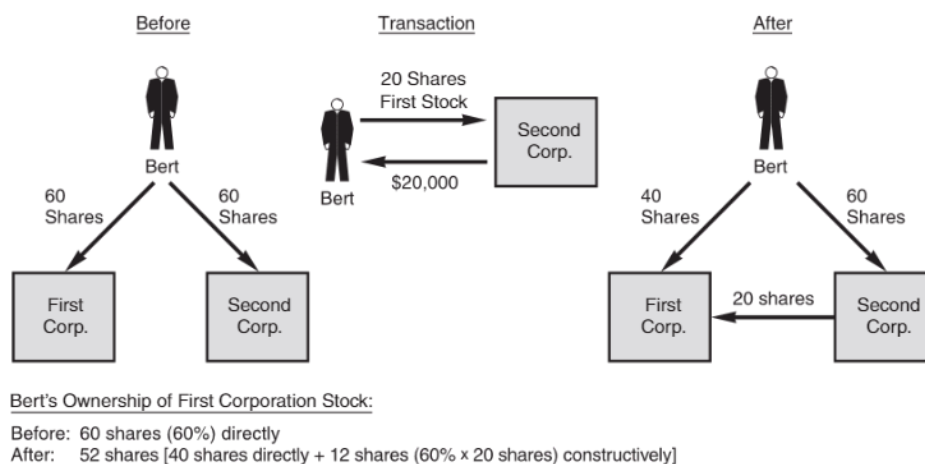


FIGURE C:4-1 ▶ ILLUSTRATION OF A BROTHER-SISTER REDEMPTION (EXAMPLE C:4-45)

Redemption Treated as a Sale. If the redemption qualifies for sale treatment, the shareholder's recognized gain or loss equals the difference between the amount received from the acquiring corporation and the shareholder's basis in the surrendered shares. The acquiring corporation is treated as having purchased the issuing corporation's shares and thus takes a cost basis in such shares.

EXAMPLE C:4-46 ▶ Assume the same facts as in Example C:4-45 except Bert sells to Second Corporation for \$40,000 40 shares of First stock having an adjusted basis of \$20,000. After the redemption, Bert owns

⁴⁷ For Sec. 304 purposes, the attribution rules of Sec. 318(a) are modified so that a shareholder is considered to own an amount of stock proportionate to

that owned by any corporation of which he or she owns 5% or more (instead of 50% or more) of the value of the stock.

44 shares of First stock (20 shares directly and 24 $[0.60 \times 40]$ shares constructively through Second). Therefore, he meets both the 50% and the 80% tests for a substantially disproportionate redemption, treats the redemption as a sale, and recognizes a capital gain of \$20,000 (\$40,000 received from Second – \$20,000 adjusted basis in the First shares). Second's basis in the First shares acquired from Bert equals the \$40,000 stock purchase price. ◀

ADDITIONAL COMMENT

The definition of a parent-subsidary relationship for Sec. 304 differs from the definition for controlled groups or affiliated corporations discussed in Chapter C:3.

PARENT-SUBSIDIARY CORPORATIONS

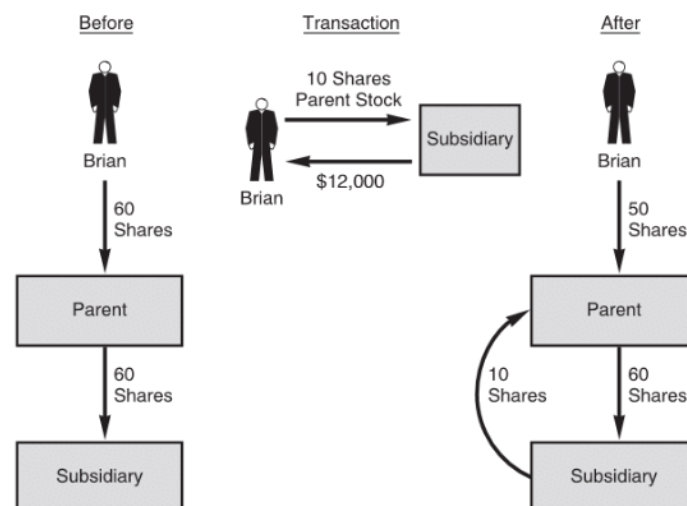
If a shareholder sells stock in a parent corporation to a subsidiary of the parent, the sale is treated as a distribution in redemption of part or all of the shareholder's parent stock. A parent-subsidary relationship exists if one corporation owns at least 50% of the voting power or 50% of the total value of all stock in another corporation.

To determine whether the redemption is treated as a sale or a dividend, reference is made to the shareholder's ownership of parent stock before and after the redemption. In this determination, the constructive ownership rules of Sec. 318 apply.

Redemption Treated as a Dividend. If the redemption does not qualify for sale treatment, the distribution is treated as a dividend, first from the subsidiary to the extent of its E&P and then from the parent to the extent of its E&P. This rule effectively sets the combined E&P of both corporations as the standard for measuring the amount of the distribution that constitutes a dividend. The shareholder's basis in his or her remaining parent shares is increased by his or her basis in the shares transferred to the subsidiary. The subsidiary's basis in the parent stock is the amount the subsidiary paid for the stock.⁴⁸

EXAMPLE C:4-47 ►

Of the 100 shares of Parent Corporation stock, Brian owns 60 shares with a \$15,000 basis. Parent owns 60 of the 100 shares of Subsidiary stock. Parent and Subsidiary have \$10,000 and \$30,000 of E&P, respectively. Brian sells ten of his Parent shares to Subsidiary for \$12,000. (See Figure C:4-2 for an illustration.) Parent is deemed to have redeemed its stock from Brian, who owned 60% of Parent stock before the redemption and 53 shares (50 shares directly and 3 $[0.60 \times 0.50 \times 10]$ shares constructively) after the redemption. Because the 50% and 80% tests of Sec. 302(b)(2) are not met, the redemption is not substantially disproportionate and thus does not qualify for sale treatment. Therefore, it is treated as a distribution subject to Sec. 301. Under this provision, Brian recognizes



Brian's Ownership of Parent Corporation Stock:

Before: 60 shares (60%) directly

After: 53 shares [50 shares directly + 3 shares $(50\% \times 60\% \times 10 \text{ shares})$ constructively]

FIGURE C:4-2 ► ILLUSTRATION OF A PARENT-SUBSIDIARY REDEMPTION (EXAMPLE C:4-47)

⁴⁸ Rev. Rul. 80-189, 1980-2 C.B. 106.

a \$12,000 dividend. This dividend is deemed to have been paid out of Subsidiary's E&P, which is sufficient to cover the entire distribution amount. Brian's \$2,500 basis in the redeemed shares increases his \$12,500 basis in his remaining Parent shares, so that his total basis in those shares remains \$15,000. Subsidiary's basis in the ten Parent shares acquired from Brian is \$12,000, the amount that Subsidiary paid for the shares. ◀

Redemption Treated as a Sale. If the redemption of the parent's stock qualifies for sale treatment, the basis of the stock transferred to the subsidiary is subtracted from the amount realized in the distribution to derive the shareholder's recognized gain or loss.

EXAMPLE C:4-48 ▶ Assume the same facts as in Example C:4-47 except Brian sells 40 shares of Parent stock to Subsidiary for \$48,000. Because Brian owns 60% of Parent stock before the redemption and 24.8% (20 shares directly and $4.8 [0.60 \times 0.20 \times 40]$ shares constructively) after the redemption, the redemption meets the Sec. 302(b)(2) 50% and 80% tests for a substantially disproportionate redemption. Consequently, Brian recognizes a capital gain of \$38,000 (\$48,000 selling price – \$10,000 adjusted basis in the 40 shares sold). Brian's adjusted basis in his remaining 20 shares of Parent stock is \$5,000. Subsidiary's basis in the 40 Parent shares purchased from Brian is \$48,000, the amount that Subsidiary paid for the shares. ◀

Topic Review C:4-5 summarizes the alternative treatments of stock redemptions.

TOPIC REVIEW C:4-5

Alternative Treatments of Stock Redemptions

General Rule: A distribution in redemption of stock generally is treated as a dividend (Secs. 302(d) and 301).

Exception: The following transactions qualify for sale (i.e., capital gains) treatment:

1. Redemptions that are not essentially equivalent to a dividend (Sec. 302(b)(1))
2. Substantially disproportionate redemptions (Sec. 302(b)(2))
3. Complete terminations of a shareholder's interest (Sec. 302(b)(3))
4. Partial liquidations in redemption of a noncorporate shareholder's stock (Sec. 302(b)(4))
5. Redemptions to pay death taxes (Sec. 303)

Special Redemption Rules

1. Redemptions of Sec. 306 preferred stock generally are taxed as dividends to the shareholder (Sec. 306).
2. A sale of stock in one controlled corporation to another controlled corporation is treated as a redemption (Sec. 304).

TAX PLANNING CONSIDERATIONS

OBJECTIVE 8

Identify tax planning opportunities in nonliquidating distributions

AVOIDING UNREASONABLE COMPENSATION

Chapter C:3 discussed the use of salary and fringe benefits to permit a shareholder of a closely held corporation to withdraw funds from the corporation and be subject to a single level of taxation. If a corporation pays too large a salary to a shareholder-employee, some of the salary may be disallowed as a corporate deduction while still taxed to the shareholder-employee as a constructive dividend. In such case, double taxation of the disallowed portion results.

Corporations can avoid this result by entering into a hedge agreement with a shareholder-employee. This agreement obligates the shareholder-employee to repay any portion of salary the IRS disallows as a corporate deduction. Under Sec. 162, the shareholder-employee may deduct this amount in the year he or she repays it, provided state law imposes

a legal obligation to repay.⁴⁹ If a hedge agreement is not in effect, voluntary repayment of the salary is not deductible by the shareholder-employee.⁵⁰

EXAMPLE C:4-49 ► Theresa owns one-half the stock in Marine Corporation and serves as its president. The remaining Marine stock is owned by eight investors, none of whom owns more than 10% of the outstanding shares. In Year 1, Theresa and Marine conclude a hedge agreement requiring Theresa to repay all compensation the IRS declares unreasonable. In Year 3, Marine pays Theresa a salary and bonus of \$750,000. The IRS subsequently claims that \$300,000 of the salary is unreasonable and thus nondeductible by Marine. After protracted negotiations, Marine and the IRS settle on \$180,000 as unreasonable and nondeductible by Marine. Theresa repays the \$180,000 in Year 6. The entire \$750,000 is taxable to Theresa in Year 3. However, she can deduct the \$180,000 as a trade or business expense in Year 6. ◀

Hedge agreements also have been used in connection with other payments between a corporation and its shareholders (e.g., travel and entertainment expenses). Some employers are averse to hedge agreements because the IRS might consider the very existence of such an agreement as evidence of unreasonable compensation.

BOOTSTRAP ACQUISITIONS

A prospective purchaser who wants to acquire stock in a corporation may not have sufficient cash to do so. To facilitate the purchase, corporate funds could be used in the following way: a shareholder sells part of his or her stock to the purchaser and then causes the corporation to redeem the shareholder's remaining shares. Such an arrangement is called a bootstrap acquisition.

EXAMPLE C:4-50 ► Ted owns all 100 shares of Dragon Corporation stock having a \$100,000 FMV. Vickie wants to purchase the stock from Ted but has only \$60,000 in cash. Dragon has a large cash balance, which it does not need for its operations. Ted sells Vickie 60 Dragon shares for \$60,000 and then causes Dragon to redeem his remaining shares for \$40,000. The redemption qualifies as a complete termination of Ted's interest under Sec. 302(b)(3) and, therefore, is eligible for sale treatment. ◀

Court cases have held that such redemptions qualify for sale treatment as long as the third-party sale and redemption are part of an integral plan to terminate the seller's entire corporate interest. Whether the redemption precedes the sale is immaterial.⁵¹ The purchaser, however, must carefully avoid generating a dividend, actual or constructive. For example, a purchaser who contracts to acquire all the stock in a corporation on an installment basis and then causes the corporation to pay the installment obligations will recognize dividend income. The use of corporate funds results in a constructive dividend to the purchaser where the corporation discharges the purchaser's legal obligation. Even if the corporation uses its own funds to redeem the seller's shares, a purchaser who was legally obligated to purchase the shares is considered to have received a constructive dividend.⁵²

EXAMPLE C:4-51 ► Assume the same facts as in Example C:4-50 except that, after Vickie purchases the 60 shares from Ted, she becomes legally obligated to purchase Ted's remaining 40 shares. After entering into the contract, Vickie causes Dragon Corporation to redeem the 40 shares. Because Dragon has extinguished Vickie's legal obligation, the corporation is deemed to have paid Vickie a \$40,000 constructive dividend. No constructive dividend would have resulted had Vickie been legally obligated to purchase only 60 shares from Ted. ◀

Rev. Rul. 69-608 provides guidance to a bootstrap acquirer on how to avoid constructive dividend treatment.⁵³ According to this ruling, when the corporation redeems some of the seller's shares, the buyer will not be deemed to have received a constructive dividend as

⁴⁹ Rev. Rul. 69-115, 1969-1 C.B. 50, and *Vincent E. Oswald*, 49 T.C. 645 (1968), *acq.* 1968-2 C.B. 2.

⁵⁰ *Ernest H. Berger*, 37 T.C. 1026 (1962), and *John G. Pahl*, 67 T.C. 286 (1976).

⁵¹ See, for example, *U.S. v. Gerald Carey*, 7 AFTR 2d 1301, 61-1 USTC ¶9428 (8th Cir., 1961).

⁵² *H. F. Wall v. U.S.*, 36 AFTR 423, 47-2 USTC ¶9395 (4th Cir., 1947).

⁵³ Rev. Rul. 69-608, 1969-2 C.B. 42.

WHAT WOULD YOU DO IN THIS SITUATION?



One of the most cherished traditions observed by many professional firms centers around the year-end bonus. Legal, medical, business, and accounting administrators often use bonus compensation to clear the books at the end of the year. In partnerships, bonuses are characterized as distributive shares or a form of compensation. As such, they are taxed only once as income paid to professionals for services rendered, net of appropriate accounting adjustments.

With the advent of the professional corporation, an entity intended to limit personal liability, many professionals have opted to do business as shareholders. The continued use of the year-end bonus in the professional corporation has come under close IRS scrutiny. The position taken by the IRS is clear. If the payments to the shareholder-professional are in exchange for his or her services rendered to the firm, the corporation may deduct them as salaries (assuming they are reasonable in amount). On the other hand, if they are a disguised bailout of owners' profits, the corporation cannot deduct them. As a result, the corporation's taxable income will be increased by the amount of the disallowed deduction. The shareholder who receives the bonus must treat it as a dividend rather than salary. However, treating the bonus as a dividend generally results in less tax paid by the shareholder because dividends are taxed at a

maximum rate of 23.8% (including the 3.8% net investment tax rate) as opposed to 37% for salary. The consequences are negative only to the corporation, which may not deduct the dividend payment.

This principle is illustrated in a case, *Rapco, Inc. v. CIR*, 77 AFTR 2d 2405, 96-1 USTC ¶150,297 (CA-2, 1996), decided by the Second Circuit. In *Rapco*, the court denied a deduction for bonus payments to the president of the company, even though he played a significant role in the company's rapid growth and had guaranteed third party loans to Rapco. Reasons cited by the court were that Rapco's compensation scheme was "bonus-heavy and salary light," suggesting dividend avoidance; Rapco had ignored its own bonus policy set forth in its preincorporation minutes; the corporation had a history of never paying dividends; the shareholder who determined the amount of his own salary owned 95% of the corporation's stock; and Rapco's own expert testified that \$400,000 to \$500,000 was fair compensation for the president's services. (The IRS allowed a salary deduction of \$405,000.)

Assuming your CPA firm is acting as a tax advisor to several similarly situated professional corporations, what advice that complies with the IRC, Treasury Regulations, and the AICPA's *Statements on Standards for Tax Services* would you give?

long as he or she does not have a primary and unconditional obligation to purchase the shares, and the corporation pays no more for the redeemed shares than their FMV. Furthermore, a purchaser who has an option—not a legal obligation—to purchase the seller's remaining shares, and who assigns the option to the redeeming corporation, is unlikely to generate a constructive dividend.⁵⁴

TIMING OF DISTRIBUTIONS

Dividends can be paid only out of a corporation's E&P. Therefore, if a distribution can be made when the corporation has little or no E&P, it will be treated as a return of capital rather than as a dividend.

If a corporation generates a current E&P deficit, the deficit reduces accumulated E&P evenly throughout the year unless the corporation can demonstrate that it incurred the deficits on particular dates. Thus, if a corporation with a current E&P deficit, but a positive accumulated E&P balance, makes a distribution in the current year, the timing of the distribution will be critical in determining whether the distribution should be treated as a dividend or as a return of capital.

EXAMPLE C:4-52

▶ Major Corporation has a \$30,000 accumulated E&P balance at the beginning of the year and incurs a \$50,000 deficit during the year. Because of its poor operating performance, Major pays to its sole shareholder only two of its four \$5,000 quarterly dividends, specifically those usually paid on March 31 and June 30. The tax treatment of the two distributions is determined as follows:

⁵⁴ *Joseph R. Holsey v. CIR*, 2 AFTR 2d 5660, 58-2 USTC ¶9816 (3rd Cir., 1958).

E&P balance, January 1	\$30,000
Minus: Reduction for first quarter loss	(12,500)
Reduction for March 31 distribution	(5,000)
E&P balance, April 1	\$12,500
Minus: Reduction for second quarter loss	(12,500)
E&P balance, June 30	\$ -0-

The first and second quarter losses each are \$12,500 $[(\$50,000) \times 0.25 = (\$12,500)]$.

The operating loss reduces the accumulated E&P balance evenly throughout the year. All of the March 31 distribution is taxable because the corporation did not incur sufficient losses to offset the positive accumulated E&P balance at the beginning of the year. The second quarter loss results in return of capital treatment for the June 30 distribution and any other distributions before year-end (assuming that the shareholder's basis in his or her stock exceeds the distribution amount). Delaying all the distributions until late in the year could result in a non-taxable return of capital. ◀

The timing of a distribution also can be critical if the distributing corporation has an accumulated E&P deficit and a positive current E&P balance.

EXAMPLE C:4-53 ► At the beginning of Year 1, Yankee Corporation has an accumulated E&P deficit of \$250,000. During Year 1 and Year 2, Yankee reports the following current E&P balances and makes the following distributions to Joe, its sole shareholder:

<u>Year</u>	<u>Current E&P</u>	<u>Distributions</u>	<u>Distribution Date</u>
1	\$100,000	\$75,000	December 31
2	-0-	-0-	None

The \$75,000 distribution in Year 1 is taxable as a dividend. The \$25,000 of current E&P that is not distributed reduces Yankee's accumulated E&P deficit to \$225,000. Had Yankee delayed distributing the \$75,000 until sometime in Year 2, the distribution would have been treated as a nontaxable return of Joe's capital. ◀

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 9

Comply with procedural rules for nonliquidating distributions

ADDITIONAL COMMENT

Information on basis adjustments for nontaxable dividends, stock splits, stock dividends, etc. for individual firms can be found in special tax services.

KEY POINT

The limitations period extends to one year beyond the date a shareholder notifies the IRS that a forbidden interest has been acquired. Otherwise, it would be almost impossible for the IRS to administer this provision.

CORPORATE REPORTING OF NONDIVIDEND DISTRIBUTIONS

A corporation that makes a nondividend distribution to its shareholders must file with its income tax return Form 5452 (Corporate Report of Nondividend Distributions), along with supporting computations. Form 5452 reports the distributing corporation's E&P so as to enable the IRS to verify the tax treatment of the distribution. Form 5452 requires the following information: current and accumulated E&P, distribution amounts paid to shareholders during the tax year, the percentage of each payment that is taxable and nontaxable, and a detailed computation of E&P from the date of incorporation.

AGREEMENT TO TERMINATE INTEREST UNDER SEC. 302(B)(3)

As mentioned earlier, if a redemption completely terminates a shareholder's interest in a corporation, the family attribution rules of Sec. 318(a)(1) may be waived. To have the rules waived, the shareholder must agree in writing that he or she will notify the IRS upon acquiring any prohibited interest within the ten-year period following the redemption. A copy of this agreement (in the form of a signed statement in duplicate) must be attached to the first return filed by the shareholder for the tax year in which the redemption occurs. If the agreement cannot be filed on time, the IRS may grant an extension. Regulation Sec. 1.302-4(a) provides that an extension will be granted only if reasonable cause exists for

failure to timely file the agreement and if the request for such an extension is filed within such time as the appropriate IRS official considers reasonable in the circumstances.

Treasury Regulations do not indicate what constitutes reasonable cause for failure to file or what constitutes a reasonable extension of time. In *Edward J. Fehrs* the U.S. Court of Claims held that late filing of a ten-year agreement was permissible where a taxpayer could not reasonably have expected that a filing would be necessary, where the taxpayer filed the agreement promptly after receiving notice that it was required, and where the agreement was filed before the issues in question were presented for trial.⁵⁵ However, in *Robin Haft Trust*, an agreement was filed *after* an adverse court ruling. In an appeal for a rehearing, the judge ruled that the filing of the agreement after the case was brought to trial was too late. Consequently, the judge denied the appeal for a rehearing.⁵⁶

If the shareholder acquires a prohibited interest within the ten-year period following the redemption, the IRS may assess additional taxes. Such an acquisition ordinarily results in recasting the redemption as a dividend rather than a sale. The limitations period for assessing additional taxes extends to one year after the date the shareholder files with the IRS notice of acquiring the prohibited interest.⁵⁷

PROBLEM MATERIALS

DISCUSSION QUESTIONS

- C:4-1** Explain how a corporation computes its current and accumulated E&P balances.
- C:4-2** Why is it necessary to distinguish between current and accumulated E&P?
- C:4-3** Describe the effect of a \$100,000 cash distribution paid on January 1 to the sole shareholder of a calendar year corporation whose stock basis is \$25,000 when the corporation has
- \$100,000 of current E&P and \$100,000 of accumulated E&P
 - A \$50,000 accumulated E&P deficit and a \$60,000 current E&P balance
 - A \$60,000 accumulated E&P deficit and a \$60,000 current E&P deficit
 - An \$80,000 current E&P deficit and a \$100,000 accumulated E&P balance
- Answer Parts a through d again, assuming instead that the corporation makes the distribution on October 1 in a nonleap year.
- C:4-4** Pecan Corporation distributes land to a noncorporate shareholder. Explain how the following items are determined:
- The amount of the distribution
 - The amount of the dividend
 - The shareholder's basis in the land
 - When the holding period for the land begins. How would your answers change if the distribution were made to a corporate shareholder?
- C:4-5** What effect do the following transactions have on the calculation of Young Corporation's current E&P? Assume that the starting point for the calculation is Young's taxable income for the current year.
- The corporation earns tax-exempt interest income of \$10,000.
 - Taxable income includes a \$10,000 dividend and is reduced by a \$7,000 dividends-received deduction.
 - A \$5,000 capital loss carryover from the preceding tax year offsets \$5,000 of capital gains.
 - The corporation accrued federal income taxes of \$25,280.
- C:4-6** Badger Corporation was incorporated in the current year. It reports an \$8,000 NOL on its initial tax return. Badger distributes \$2,500 to its shareholders. Is it possible for this distribution to be taxed as a dividend to Badger's shareholders? Explain.
- C:4-7** Does the timing of a distribution matter as to whether it is taxed as a dividend or treated as a return of capital? Explain.
- C:4-8** Hickory Corporation owns a building with a \$160,000 adjusted basis and a \$120,000 FMV. Hickory's E&P is \$200,000. Should the corporation sell the building and distribute the sales proceeds to its shareholders or distribute the property to its shareholders and let them sell it? Why?

⁵⁵ *Edward J. Fehrs v. U.S.*, 40 AFTR 2d 77-5040, 77-1 USTC ¶9423 (Ct. Cl., 1977).

⁵⁶ *Robin Haft Trust*, 62 T.C. 145 (1974).

⁵⁷ Sec. 302(c)(2)(A).

- C:4-9** Walnut Corporation owns a building with a \$120,000 adjusted basis and a \$160,000 FMV. Walnut's E&P is \$200,000. Should the corporation sell the building and distribute the sales proceeds to its shareholders or distribute the building to its shareholders and let them sell it? Why?
- C:4-10** What is a constructive dividend? Under what circumstances is the IRS likely to argue that a constructive dividend has been paid?
- C:4-11** Why are stock dividends generally nontaxable? Under what circumstances are stock dividends taxable?
- C:4-12** What is a stock redemption? What are some reasons for redeeming stock? Why are some redemptions treated as sales and others as dividends?
- C:4-13** Field Corporation redeems 100 shares of its stock from Andrew for \$10,000. Andrew's basis in the shares is \$8,000. Explain possible alternative tax treatments of Andrew's receiving the \$10,000.
- C:4-14** What conditions must be met for a redemption to be treated as a sale by the redeeming shareholder?
- C:4-15** Explain the purpose of the attribution rules in determining stock ownership in a redemption. Describe the four types of attribution rules that apply to redemptions.
- C:4-16** Abel, the sole shareholder of Ace Corporation, has an opportunity to purchase the assets of a sole proprietorship for \$50,000 in cash. Ace has a substantial E&P balance. Abel does not have sufficient cash to personally make the purchase. If Abel obtains the needed \$50,000 from Ace via a nonliquidating distribution, Abel will have to recognize dividend income. Alternatively, would Ace's purchase of the assets of the sole proprietorship followed by their distribution to Abel in redemption of part of his stock holdings constitute a partial liquidation? Explain.
- C:4-17** Why does a redemption that qualifies for sale treatment under Sec. 303 usually result in the shareholder's recognizing little or no gain or loss?
- C:4-18** Under what circumstances does a corporation recognize gain or loss when it distributes noncash property in redemption of its stock? What effect does a redemption distribution have on the distributing corporation's E&P?
- C:4-19** What is a preferred stock bailout? How does Sec. 306 operate to prevent a shareholder from realizing the otherwise available tax benefits of a preferred stock bailout?
- C:4-20** Explain the tax consequences, to both the corporation and a shareholder-employee, of an IRS determination that a portion of the compensation paid in a prior tax year is unreasonable. What steps can the corporation and shareholder-employee take to avoid the double taxation usually associated with such a determination?
- C:4-21** What is a bootstrap acquisition? What are the tax consequences of such a transaction?

ISSUE IDENTIFICATION QUESTIONS

- C:4-22** Marsha receives a \$10,000 cash distribution from Dye Corporation in April of the current year. At the beginning of the year, Dye has \$4,000 of accumulated E&P and \$8,000 of current E&P. Dye also distributed \$10,000 in cash to Barbara, who purchased all 200 shares of Dye stock from Marsha in June of the current year. What tax issues should be considered with respect to the distributions to Marsha and Barbara?
- C:4-23** Neil purchased land from Spring Harbor, his 100%-owned corporation, for \$275,000. The corporation purchased the land three years ago for \$300,000. Similar tracts of land located nearby have sold for \$400,000 in recent months. What tax issues should be considered with respect to the corporation's sale of the land?
- C:4-24** Price Corporation has 100 shares of common stock outstanding. Price repurchased all of Penny's 30 shares for \$35,000 cash during the current year. Three years ago, Penny received the shares as a gift from her mother. Her basis in the shares is \$16,000. Price has \$100,000 of current and accumulated E&P. Penny's mother owns 40 of the remaining shares; unrelated individuals own the other 30 shares. What tax issues should be considered with respect to the corporation's purchase of Penny's shares?
- C:4-25** George owns all 100 shares of Gumby's Pizza Corporation. The shares are worth \$200,000, while George's basis is only \$70,000. Mary and George have reached a tentative agreement under which George will sell all his shares to Mary. However, Mary is unwilling to pay more

than \$150,000 for the stock because the corporation currently has an excess cash balance. They have agreed that George can withdraw \$50,000 in cash from Gumby's before the stock sale. What tax issues should be considered with respect to George and Mary's agreement?

PROBLEMS

C:4-26 *Current E&P Calculation.* Alabre Corporation has 150,000 shares of common stock outstanding and pays quarterly dividends of \$0.15 per share. At the beginning of the current year, the balance in its accumulated E&P account is \$23,000. Alabre would like to have sufficient E&P to pay its dividends in the current year. To do so, what minimum amount of E&P must the corporation generate in the current year?

C:4-27 *Current E&P Calculation.* Beach Corporation, an accrual basis taxpayer, reports the following results for the current year:

Income:	
Gross profit from manufacturing operations	\$250,000
Dividends received from 25%-owned domestic corporation	20,000
Interest income: Corporate bonds	10,000
Municipal bonds	12,000
Proceeds from life insurance policy on key employee	100,000
Section 1231 gain on sale of land	8,000
Expenses:	
Administrative expenses	110,000
Bad debts	5,000
Depreciation:	
Financial accounting	68,000
Taxable income	86,000
Alternative depreciation system (for E&P)	42,000
NOL carryover	40,000
Charitable contributions: Current year	8,000
Carryover from last year	3,500
Capital loss on sale of stock	1,200
Penalty on late payment of federal taxes	450

- What is Beach's taxable income?
- What is Beach's current E&P?

C:4-28 *Current E&P Computation.* Water Corporation reports \$500,000 of taxable income for the current year. The following additional information is available:

- For the current year, Water reports an \$80,000 long-term capital loss and no capital gains.
- Taxable income includes \$80,000 of dividends from a 10%-owned domestic corporation.
- Water paid fines and penalties of \$6,000 that were not deducted in computing taxable income.
- In computing this year's taxable income, Water deducted a \$20,000 NOL carryover from a prior tax year.
- Taxable income includes a deduction for \$40,000 of depreciation that exceeds the depreciation allowed for E&P purposes.

Assume a 21% corporate tax rate. What is Water's current E&P for this year?

C:4-29 *Calculating Accumulated E&P.* Investors formed Peach Corporation in Year 1. Its current E&P (or current E&P deficit) and distributions for Years 1 through 4 are as follows:

Year	Current E&P (Deficit)	Distributions
1	\$ (8,000)	\$ 2,000
2	(12,000)	—0—
3	10,000	5,000
4	14,000	17,000

What is Peach's accumulated E&P at the beginning of Years 1 through 4?

- C:4-30** *Consequences of a Single Cash Distribution.* Clover Corporation is a calendar year taxpayer. Connie owns all of its stock. Her basis in the stock is \$10,000. On April 1 of the current (non-leap) year Clover distributes \$52,000 to Connie. Determine the tax consequences of the cash distribution in each of the following independent situations:
- Current E&P of \$15,000; accumulated E&P of \$25,000.
 - Current E&P of \$30,000; accumulated E&P deficit of (\$20,000).
 - Current E&P deficit of (\$73,000); accumulated E&P of \$50,000.
 - Current E&P deficit of (\$20,000); accumulated E&P deficit of (\$15,000).
- C:4-31** *Consequences of a Single Cash Distribution.* Pink Corporation is a calendar year taxpayer. Pete owns one-third (100 shares) of Pink stock. His basis in the stock is \$25,000. Cheryl owns two-thirds (200 shares) of Pink stock. Her basis in the stock is \$40,000. On June 10 of the current year, Pink distributes \$40,000 to Pete and \$80,000 to Cheryl. Determine the tax consequences of the cash distributions to Pete and Cheryl in each of the following independent situations:
- Current E&P of \$60,000; accumulated E&P of \$100,000.
 - Current E&P of \$36,000; accumulated E&P of \$30,000.
- C:4-32** *Consequences of Multiple Cash Distributions.* At the beginning of the current (non-leap) year, Charles owns all of Pearl Corporation's outstanding stock. His basis in the stock is \$80,000. On July 1, he sells all his stock to Donald for \$125,000. During the year, Pearl, a calendar year taxpayer, makes two cash distributions: \$60,000 on March 1 to Charles and \$90,000 on September 1 to Donald. How are these distributions treated in the following independent situations? What are the amount and character of Charles' gain on his sale of stock to Donald? What is Donald's basis in his Pearl stock at the end of the year?
- Current E&P of \$40,000; accumulated E&P of \$30,000.
 - Current E&P of \$100,000; accumulated E&P (deficit) of (\$50,000).
 - Current E&P (deficit) of (\$36,500); accumulated E&P of \$120,000.
- C:4-33** *Distribution of Appreciated Property.* In the current year, Sedgwick Corporation has \$100,000 of current and accumulated E&P. On March 3, Sedgwick distributes to its shareholder Dina a parcel of land (a capital asset) having a \$56,000 FMV. The land has a \$40,000 adjusted basis (for both taxable income and E&P purposes) to Sedgwick and is subject to an \$8,000 mortgage, which Dina assumes. Assume a 21% corporate tax rate.
- What are the amount and character of the income Dina recognizes as a result of the distribution?
 - What is Dina's basis in the land?
 - What are the amount and character of Sedgwick's gain or loss as a result of the distribution?
 - What effect does the distribution have on Sedgwick's E&P?
- C:4-34** *Distribution of Property Subject to a Liability.* On May 10 of the current year, Stowe Corporation distributes to its shareholder Arlene \$20,000 in cash and land (a capital asset) having a \$50,000 FMV. The land has a \$15,000 adjusted basis (for both taxable income and E&P purposes) and is subject to a \$60,000 mortgage, which Arlene assumes. Stowe has an E&P balance exceeding the amount distributed and is subject to a 21% corporate tax rate.
- What are the amount and character of the income Arlene recognizes as a result of the distribution?
 - What is Arlene's basis in the land?
 - What are the amount and character of Stowe's gain or loss as a result of the distribution?
- C:4-35** *Distribution of Depreciable Property.* On May 15 of the current year, Quick Corporation distributes to its shareholder Calvin a building having a \$250,000 FMV and used in Quick's business. The building originally cost \$180,000. Quick claimed \$30,000 of straight-line depreciation, so that the adjusted basis of the building on the date of distribution for taxable income purposes is \$150,000. The adjusted basis of the building for E&P purposes is \$160,000. The building is subject to an \$80,000 mortgage, which Calvin assumes. Quick has an E&P balance exceeding the amount distributed and is subject to a 21% tax rate.
- What are the amount and character of the income Calvin recognizes as a result of the distribution?
 - What is Calvin's basis in the building?

- c. What are the amount and character of Quick's gain or loss as a result of the distribution?
- d. What effect does the distribution have on Quick's E&P?

C:4-36 *Distribution of Various Types of Property.* During the current year, Zeta Corporation distributes the assets listed below to its sole shareholder, Susan. For each asset listed, determine the gross income recognized by Susan, her basis in the asset, the amount of gain or loss recognized by Zeta, and the effect of the distribution on Zeta's E&P. Assume that Zeta has an E&P balance exceeding the amount distributed and is subject to a 21% tax rate. Unless stated otherwise, adjusted bases for taxable income and E&P purposes are the same.

- a. A parcel of land used in Zeta's business that has a \$200,000 FMV and a \$125,000 adjusted basis.
- b. Assume the same facts as in Part a except that the land is subject to a \$140,000 mortgage.
- c. FIFO inventory having a \$25,000 FMV and an \$18,000 adjusted basis.
- d. A building used in Zeta's business having an original cost of \$225,000, a \$450,000 FMV, and a \$150,000 adjusted basis for taxable income purposes. Zeta has claimed \$75,000 of depreciation for taxable income purposes under the straight-line method. Depreciation for E&P purposes is \$60,000.
- e. An automobile used in Zeta's business having an original cost of \$12,000, an \$8,000 FMV, and a \$5,760 adjusted basis. For taxable income purposes, Zeta has claimed \$6,240 of MACRS depreciation on the automobile. For E&P purposes, depreciation is \$5,200.
- f. Installment obligations having a \$35,000 face amount (and FMV) and a \$24,500 adjusted basis. The obligations were created when Zeta sold a Sec. 1231 asset.

C:4-37 *Disguised Dividends.* King Corporation is a profitable manufacturing concern with \$800,000 of E&P. It is owned in equal shares by Harry and Wilma, husband and wife. Both individuals are actively involved in the business. Determine the tax consequences of the following independent events:

- a. In reviewing a prior year tax return for King, the IRS determines that the \$500,000 of salary and bonuses paid to Wilma is unreasonable and that reasonable compensation is \$280,000.
- b. King loaned Harry \$400,000 over the past three years. None of the money has been repaid. Harry does not pay interest on the loans.
- c. King sells a building to Wilma for \$150,000 in cash. The property has an adjusted basis of \$90,000 and is subject to a \$60,000 mortgage, which Wilma assumes. The FMV of the building is \$350,000.
- d. Harry leases a warehouse to King for \$50,000 per year. According to an IRS auditor, similar warehouses can be leased for \$35,000 per year.
- e. Wilma sells to King for \$250,000 land on which King intends to build a factory. According to a recent appraisal, the FMV of the land is \$185,000.
- f. The corporation owns an airplane that it uses to fly executives to business meetings. When the airplane is not being used for business, Harry and Wilma use it to travel to their ranch in Idaho for short vacations. The approximate cost of their trips to the ranch in the current year is \$8,000.

C:4-38 *Unreasonable Compensation.* Forward Corporation is owned by a group of 15 shareholders. During the current year, Forward pays \$550,000 in salary and bonuses to Alvin, its president and controlling shareholder. The corporation's tax rate is 21%, and Alvin's marginal tax rate is 37% for ordinary income and 23.8% (20% + 3.8% on net investment income) for long-term capital gains. The IRS audits Forward's tax return and determines that reasonable compensation for Alvin is \$350,000. Forward agrees to the adjustment. What effect does the disallowance of part of the salary and bonus deduction have on Forward's and Alvin's respective tax positions? Ignore payroll taxes, such as FICA.

C:4-39 *Stock Dividend Distribution.* Wilton Corporation has a single class of common stock outstanding. Robert owns 100 shares, which he purchased six years ago for \$100,000. In the current year, when the stock is worth \$1,200 per share, Wilton declares a 10% dividend payable in common stock. On December 10 of the current year, Robert receives ten additional shares. On January 30 of the subsequent year, he sells five of the ten shares for \$7,000.

- a. How much income must Robert recognize when he receives the stock dividend?
- b. How much gain or loss must Robert recognize when he sells the common stock?
- c. What is Robert's basis in his remaining common shares? When does his holding period in the new common shares begin?

- C:4-40** *Stock Dividend Distribution.* Moss Corporation has a single class of common stock outstanding. Tillie owns 1,000 shares, which she purchased five years ago for \$100,000. Moss declares a stock dividend payable in 8% preferred stock having a \$100 par value. Each shareholder receives one share of preferred stock for ten shares of common stock. On the distribution date—December 16 of the current year—the common stock was worth \$180 per share, and the preferred stock was worth \$100 per share. On April 1 of the current year, Tillie sells half of her preferred stock for \$5,000.
- How much income must Tillie recognize when she receives the stock dividend?
 - How much gain or loss must Tillie recognize when she sells the preferred stock? (Ignore the implications of Sec. 306.)
 - What is Tillie's basis in her remaining common and preferred shares after the sale? When does her holding period for the preferred shares begin?
- C:4-41** *Stock Rights Distribution.* Trusty Corporation has a single class of common stock outstanding. Jim owns 200 shares, which he purchased for \$50 per share two years ago. On April 10 of the current year, Trusty distributes to its common shareholders one right to purchase for \$60 one common share for each common share owned. At the time of the distribution, each common share is worth \$75, and each right is worth \$15. On September 10, Jim sells 100 rights for \$2,000 and exercises the remaining 100 rights. On November 10, he sells for \$80 each 60 of the shares acquired through exercise of the rights.
- What are the amount and character of income Jim recognizes upon receiving the rights?
 - What are the amount and character of gain or loss Jim recognizes upon selling the rights?
 - What are the amount and character of gain or loss Jim recognizes upon exercising the rights?
 - What are the amount and character of gain or loss Jim recognizes upon selling the newly acquired common shares?
 - What basis does Jim take in his remaining shares?
- C:4-42** *Attribution Rules.* George owns 100 of the 1,000 outstanding shares of Polar Corporation common stock. Under the Sec. 318 family attribution rules, to which of the following individuals will ownership of George's stock be attributed? In other words, who is deemed to constructively own George's stock?
- George's wife
 - George's father
 - George's brother
 - George's mother-in-law
 - George's daughter
 - George's son-in-law
 - George's grandfather
 - George's grandson
 - George's mother's brother (his uncle)
- C:4-43** *Attribution Rules.* Moose Corporation's 400 shares of outstanding stock are owned as follows:

<i>Name</i>	<i>Shares</i>
Lara (an individual)	60
LMN Partnership (Lara is a 20% partner)	50
LST Partnership (Lara is a 70% partner)	100
Lemon Corporation (Lara is a 30% shareholder)	100
Lime Corporation (Lara is a 60% shareholder)	90
Total	<u>400</u>

How many shares is Lara deemed to own under the Sec. 318 attribution rules?

- C:4-44** *Redemption from a Sole Shareholder.* Paul owns all 100 shares of Presto Corporation stock. His basis in the stock is \$10,000. Presto has \$100,000 of E&P. Presto redeems 25 of Paul's shares for \$30,000. What are the tax consequences of the redemption to Paul and to Presto?
- C:4-45** *Multiple Redemptions.* Four unrelated shareholders own Benton Corporation's 400 shares of outstanding stock. As indicated below, Benton redeems a total of 100 shares for \$500 per share

from three of its shareholders. Each shareholder has a \$230 per share basis in his or her stock. Benton's current and accumulated E&P at the end of the tax year is \$150,000.

<i>Shareholder</i>	<i>Shares Held Before the Redemption</i>	<i>Shares Redeemed</i>
Ethel	200	40
Fran	100	30
Georgia	50	30
Henry	50	—0—
Total	400	100

- What are the tax consequences (e.g., basis of remaining shares and amount and character of recognized income, gain, or loss) of the redemptions to Ethel, Fran, and Georgia?
- How would your answer to Part a change if Ethel were Georgia's mother?

C:4-46 *Redemption Requirements for Sale Treatment.* Of the 9,500 shares of Favor Corporation stock outstanding, Olsen owns 6,100 shares. Unrelated parties own the remaining shares. To bolster its stock price, Favor plans to reduce the total number of shares outstanding by redeeming some of the shares held by Olsen.

- To qualify the redemption as "substantially disproportionate" and thereby make it eligible for sale treatment, how many of Olsen's shares must Favor redeem?
- How would your answer change if Olsen owns only 5,800 out of 9,500 shares before the redemption?

C:4-47 *Partial Liquidation.* Unrelated parties Amy, Beth, Carla, and Delta Corporation each own 25 of the 100 outstanding shares of Axle Corporation stock. In a transaction that qualifies as a partial liquidation, Axle distributes \$20,000 cash to each shareholder in exchange for five Axle shares. Each redeemed share has a \$1,000 basis to the shareholder and a \$4,000 FMV. How does each shareholder treat the distribution for tax purposes?

C:4-48 *Redemption to Pay Death Taxes.* John died on March 3, 2019. His gross estate of \$16.5 million includes First Corporation stock (400 of the 1,000 outstanding shares) worth \$10 million or \$25,000 per share (\$10,000,000/400). This FMV amount also is the estate's basis in the stock (see Chapter C:13). John's wife, Myra, owns the remaining 600 shares. Deductible funeral and administrative expenses total \$500,000. John, Jr. is the sole beneficiary of John's estate. Estate taxes amount to \$1 million.

- Does a redemption of First Corporation stock from John's estate, John, Jr., or John's wife qualify for sale treatment under Sec. 303?
- On September 10, 2019, First Corporation redeems 200 shares of its stock from John's estate for \$6 million or \$30,000 per share (\$6,000,000/200). How does the estate treat this redemption for tax purposes?

C:4-49 *Effect of Redemption on E&P.* White Corporation has 100 shares of stock outstanding. Ann owns 40 of these shares, and unrelated individuals own the remaining 60 shares. White redeems 30 of Ann's shares for \$30,000. In the year of the redemption, White has \$30,000 of paid-in capital and \$80,000 of E&P.

- How does the redemption affect White's E&P balance if the redemption qualifies for sale treatment?
- How does the redemption affect White's E&P balance if the redemption does *not* qualify for sale treatment?

C:4-50 *Various Redemption Issues.* Alan, Barbara, and Dave are unrelated. Each has owned 100 shares of Time Corporation stock for five years and each has a \$60,000 basis in those shares. Time's E&P is \$240,000. Time redeems all 100 of Alan's shares for their \$100,000 FMV.

- What are the amount and character of Alan's recognized gain or loss? What basis do Barbara and Dave take in their remaining shares? What effect does the redemption have on Time's E&P?
- If Alan were Barbara's son, how would your answers to the questions in Part a change?
- Assume the same facts as in Part b except Alan agrees with the IRS to waive the family attribution rules. Based on this assumption, how would your answers to the questions in Part a again change?

- C:4-51** *Various Redemption Issues.* Andrew, Bea, Carl, and Carl, Jr. (Carl's son), and Tetra Corporation own all of the single class of Excel Corporation stock as follows:

<u>Shareholder</u>	<u>Shares Held</u>	<u>Adjusted Basis</u>
Andrew	20	\$3,000
Bea	30	6,000
Carl	25	4,000
Carl, Jr.	15	3,000
Tetra Corporation	10	2,000
Total	<u>100</u>	

Andrew, Bea, and Carl are unrelated. Bea owns 75% of the Tetra stock, and Andrew owns the remaining 25%. Excel's E&P is \$100,000. Determine the tax consequences of the following independent transactions to the shareholders and Excel:

- Excel redeems 25 of Bea's shares for \$30,000.
- Excel redeems 10 of Bea's shares for \$12,000.
- Excel redeems all of Carl's shares for \$30,000.
- Assume the same facts as in Part c except the stock is redeemed from Carl's estate to pay death taxes, and the entire redemption qualifies for sale treatment under Sec. 303. The stock has a \$28,000 FMV on the date of Carl's death. The alternate valuation date is not elected.
- Excel redeems all of Andrew's shares for Excel land having a \$6,000 basis for both taxable income and E&P purposes and a \$24,000 FMV. Assume a 21% corporate tax rate.
- Assume that Carl owns 25 shares of Excel stock and that Carl, Jr. owns the remaining 75 shares. Determine the tax consequences to Carl and Excel if Excel redeems all 25 of Carl's shares for \$30,000.

- C:4-52** *Various Redemption Issues.* Alice, Bob, Carol, the ABC Partnership, Franklin Corporation, and the Gleason Family Trust own shares of Holston Corporation's single class of stock as follows:

<u>Shareholder</u>	<u>Shares Held</u>	<u>Adjusted Basis</u>
Alice	300	\$ 75,000
Bob (Alice's brother)	500	125,000
Carol (Alice's daughter)	100	25,000
ABC Partnership	200	50,000
Franklin Corporation	600	150,000
Gleason Family Trust	300	75,000
Total	<u>2,000</u>	

The Holston shareholders have owned their shares for more than one year. The partners of the ABC Partnership have the following interests in the partnership: Alice 40%, Bob 30%, and Carol 30%. The shareholders of Franklin Corporation own shares as follows: Alice 10%, Bob 60%, and Carol 30%. The equal beneficiaries of the Gleason Family Trust are David (Alice's grandson) and Edgar (Bob's grandson). Alice is considering having Holston redeem some of her Holston shares in exchange for cash. On the day of the planned redemption, Holston will have \$25,000 of current E&P and \$75,000 of prior accumulated E&P. Determine the tax consequences of the following two independent transactions to Alice and Holston Corporation.

- Holston redeems 100 shares of its stock from Alice in exchange for \$80,000.
- Holston redeems 200 shares of its stock from Alice in exchange for \$160,000.

- C:4-53** *Comparison of Dividends and Redemptions.* Bailey is one of four equal unrelated shareholders of Checker Corporation. Bailey has held Checker stock for four years and has a basis in her stock of \$40,000. Checker has \$280,000 of current and accumulated E&P and distributes \$100,000 to Bailey.

- What are the tax consequences to Checker and to Bailey if Bailey is an individual and the distribution is treated as a dividend?
- In Part a, what would be the tax consequences if Bailey were a corporation?
- What are the tax consequences to Checker and to Bailey (an individual) if Bailey surrenders all her stock in a redemption qualifying for sale treatment?
- In Part c, what would be the tax consequences if Bailey were a corporation?

- e. Which treatment would Bailey prefer if Bailey were an individual? Which treatment would Bailey Corporation prefer?

C:4-54 *Preferred Stock Bailout.* Fran owns all 100 shares of Star Corporation stock. Her stock basis is \$60,000. On December 1 of the current year, Star distributes 50 shares of preferred stock to Fran in a nontaxable distribution. In the year of the distribution, Star's total E&P is \$100,000, the preferred shares are worth \$150,000, and the common shares are worth \$300,000.

- What are the tax consequences to Fran and to Star if Fran sells her preferred stock to Ken for \$200,000 on January 10 of the following year? In that year, Star's current E&P is \$75,000 (in addition to the \$100,000 balance from the prior year).
- How would your answer to Part a change if Fran sells her preferred stock to Ken for \$110,000 instead of \$200,000?
- How would your answer to Part a change if Star redeems Fran's preferred stock for \$200,000 on January 10 of the following year?

C:4-55 *Brother-Sister Redemptions.* Bob owns 60 of the 100 outstanding shares of Dazzle Corporation stock and 80 of the 100 outstanding shares of Razzle Corporation stock. Bob's basis in his Dazzle shares is \$12,000, and his basis in his Razzle shares is \$8,000. Bob sells 30 of his Dazzle shares to Razzle for \$50,000. At the end of the year of sale, Dazzle and Razzle have E&P of \$25,000 and \$40,000, respectively.

- What are the amount and character of Bob's recognized gain or loss on the sale?
- What is Bob's basis in his remaining shares of the Dazzle and Razzle stock?
- How does the sale affect the E&P of Dazzle and Razzle?
- What basis does Razzle take in the Dazzle shares it purchases?
- How would your answer to Part a change if Bob owns only 50 of the 100 outstanding shares of Razzle stock?

C:4-56 *Parent-Subsidiary Redemptions.* Jane owns 150 of the 200 outstanding shares of Parent Corporation stock. Parent owns 160 of the 200 outstanding shares of Subsidiary Corporation stock. Jane sells 50 shares of her Parent stock to Subsidiary for \$40,000. Jane's basis in her Parent shares is \$15,000 (\$100 per share). At the end of the year of sale, Subsidiary and Parent have E&P of \$60,000 and \$25,000, respectively.

- What are the amount and character of Jane's recognized gain or loss on the sale?
- What is Jane's basis in her remaining shares of Parent stock?
- How does the sale affect the E&P of Parent and Subsidiary?
- What basis does Subsidiary take in the Parent shares it purchases?
- How would your answer to Part a change if Jane instead sells 100 of her Parent shares to Subsidiary for \$80,000?

C:4-57 *Bootstrap Acquisition.* Jana owns all 100 shares of Stone Corporation stock having a \$1 million FMV. Her basis in the stock is \$400,000. Stone's E&P balance is \$600,000. Michael would like to purchase the stock but wants only the corporation's non-cash assets valued at \$750,000. Michael is willing to pay \$750,000 for these assets.

- What are the tax consequences to Jana, Michael, and Stone if Michael purchases 75 shares of Stone stock for \$750,000 and Stone redeems Jana's remaining 25 shares for \$250,000 cash?
- How would your answer to Part a change (if at all) if Stone first redeems 25 shares of Jana's stock for \$250,000 and then Michael purchases the remaining 75 shares from Jana for \$750,000?

COMPREHENSIVE PROBLEM

C:4-58 Several years ago, Brian formed Sigma Corporation, a retail company. Sigma uses the accrual method of accounting. In the current year, the corporation reported the following items:

Gross profit	\$290,000
Long-term capital gain	30,000
Tax-exempt interest received	7,000
Salary paid to Brian	80,000
Payroll tax on Brian's salary (Sigma's share)	6,120
Depreciation	25,000 (\$21,000 for E&P purposes)
Other operating expenses	89,000
Dividend distribution to Brian	60,000

In addition to owning 100% of Sigma's stock, Brian manages Sigma's business and earns the \$80,000 salary listed above. This salary is an ordinary and necessary business expense of the corporation and is reasonable in amount. The payroll tax on Brian's \$80,000 salary is \$12,240, \$6,120 of which Sigma pays and deducts, and the other \$6,120 of which Brian pays through Social Security withholding. Brian is single with no dependents and claims the standard deduction.

- Calculate Sigma's and Brian's current year taxable income and total tax liability, as well as their combined tax liability. Also, calculate the corporation's current E&P after the dividend distribution.
- Assume instead that Brian operates Sigma as a sole proprietorship. In the current year, the business reports the same operating results as above, and Brian withdraws \$140,000 in lieu of the salary and dividend. Brian's self-employment tax is \$21,193 (for 2019). Compute Brian's total tax liability for the current year, assuming that he claims a \$30,641 qualified business income (QBI) deduction. Note: The calculation of the QBI deduction is covered in Chapter C:9. For now, just take this amount as given. It is deducted *from* AGI.
- Assume a C corporation such as in Part a distributes all of its after-tax earnings. Compare the tax treatment of long-term capital gains, tax-exempt interest, and operating profits if earned by a C corporation with the tax treatment of these items if earned by a sole proprietorship.

TAX STRATEGY AND CRITICAL THINKING PROBLEM

C:4-59 John owns all 100 shares of stock in Jamaica Corporation, which has \$100,000 of current E&P. John would like to receive a \$50,000 distribution from the corporation. Jamaica owns several assets that it could distribute to John. What are the tax consequences of Jamaica's distributing each of the following assets? Jamaica has a 21% tax rate and, unless stated otherwise, its bases for E&P and taxable income purposes are the same.

- \$50,000 cash.
- 100 shares of XYZ stock purchased two years ago for \$10,000 and now worth \$50,000.
- 100 shares of ABC stock purchased one year ago for \$72,000 and now worth \$50,000.
- Equipment purchased four years ago for \$120,000 that now has a tax adjusted basis of \$22,000 and an E&P adjusted basis of \$40,000. John would assume a liability of \$31,000 on the equipment. The equipment is now worth \$81,000.
- An installment obligation with a face value of \$50,000 and a basis of \$32,000. Jamaica acquired this obligation three years ago when it sold land held as an investment.
- Would your answers in Parts a–e change if Jamaica redeems 50 of John's shares for each of the properties listed?
- Based on the foregoing results, which distribution would you recommend? Which distribution(s) should be avoided?
- Would your answers in Parts a–e change if John's 100 shares represented one third of Jamaica's outstanding shares, unrelated parties owned the remaining 200 shares, and Jamaica exchanged all of John's shares for each of the properties listed?
- If John were an investor, would treating the distribution as a sale be preferable to treating the distribution as a dividend? Why or why not?

CASE STUDY PROBLEMS

C:4-60 Amy, Beth, and Meg each own 100 of the 300 outstanding shares of Theta Corporation stock. Amy wants to sell her shares, which have a \$40,000 basis and a \$100,000 FMV. Either Beth and/or Meg can purchase Amy's shares (50 shares each) or Theta can redeem all of them. Theta has a \$150,000 E&P balance.

Required: Write a memorandum comparing the tax consequences of the two options to the three sisters, who actively manage Theta.

C:4-61 Maria Garcia is a CPA whose firm has prepared the tax returns of Stanley Corporation for many years. A review of Stanley's last three tax returns by a new staff accountant, who has been assigned to the client for the first time, reveals that the corporation may be paying excessive compensation to one of its key officers. The staff accountant feels that the firm should inform the IRS and/or report the excess amount as a nondeductible dividend. Although the facts are ambiguous, they tend to support the contention that the compensation paid in current and prior years is reasonable.

Required: In a client letter, discuss Maria's role as an advocate for Stanley, and discuss the possible tax consequences resulting from a subsequent audit.

TAX RESEARCH PROBLEMS**C:4-62**

Fifteen years ago, husband and wife Stuart and Marsha Widell organized Widell Engineering Associates (WEA), a Delaware corporation that builds, repairs, and manages waste treatment plants throughout the Southwest. The Widells capitalized WEA with cash of \$500,000 and industrial equipment having an adjusted basis of \$4.5 million, each in exchange for 2,500 shares of WEA common stock. Three years later, Stuart and Marsha each gifted 500 shares of their WEA stock to their son Weymouth.

As a result of a sharp upswing in the economy, WEA's profits swelled under the joint management of Stuart and Weymouth. After ten years of joint control, however, and because of irreconcilable differences with his father, Weymouth decided to leave WEA and organize his own engineering firm, Fortunelle.

To keep WEA's business in the family and to give Stuart complete WEA management control, Stuart, Marsha, and Weymouth agreed that WEA would redeem all of Weymouth's 1,000 shares with waste treatment property worth \$8.5 million. To ensure capital gains treatment, Weymouth obtained a waiver of the family attribution rules in return for an agreement with the IRS not to acquire an equity interest in WEA for ten years and to notify the IRS if he does so. Following the redemption, Weymouth transferred the property to Fortunelle in exchange for all 8,500 shares of Fortunelle common stock.

Last year, Stuart suffered a heart attack. He now has proceeded to reconcile his differences with Weymouth. To retain Widell family control of WEA's business, Stuart, Marsha, and Weymouth propose that WEA and Fortunelle conclude an "arms length" agreement under which Fortunelle would manage WEA's waste treatment plants in return annually for 20% of WEA's gross rental revenues, but no equity interest. The Widells are convinced that the proposed arrangement does not violate either the Sec. 302 waiver rules or Weymouth's agreement with the IRS. They have asked you to draft a letter that confirms this understanding. In researching the issue, consult at a minimum the following authorities:

- IRC Sec. 302(c)(2)
- Rev. Rul. 70-104, 1970 C.B. 66
- *Chertkof v. Commissioner*, 48 AFTR 2d 81-5194, 81-1 USTC ¶9462 (4th Cir, 1981)

C:4-63

When the IRS audited Winter Corporation's current year tax return, the IRS disallowed \$10,000 of travel and entertainment expenses incurred by Charles, an officer-shareholder, because of inadequate documentation. The IRS asserted that the \$10,000 expenditure was a constructive dividend to Charles, who maintained that the expense was business related. Charles argued that he derived no personal benefit from the expenditure and therefore received no constructive dividend. Prepare a memorandum for your tax manager explaining whether the IRS's assertion or Charles's assertion is correct. Your manager has suggested that, at a minimum, you consult the following resources:

- IRC Secs. 162 and 274
- Reg. Secs. 1.274-1 and -2

C:4-64

Scott and Lynn Brown each own 50% of Benson Corporation stock. During the current year, Benson made the following distributions to its shareholders:

<u>Shareholder</u>	<u>Property Distributed</u>	<u>Adjusted Basis to Corporation</u>	<u>Property's FMV</u>
Scott Brown	Land parcel A	\$ 40,000	\$75,000
Lynn Brown	Land parcel B	120,000	75,000

Benson had E&P of \$250,000 immediately before the distributions. Prepare a memorandum for your tax manager explaining how Benson should treat these transactions for tax and financial accounting purposes. How will the two shareholders report the distributions? Benson's tax rate is 21%. Your manager has suggested that, at a minimum, you consult the following resources:

- IRC Sec. 301
- IRC Sec. 311
- IRC Sec. 312
- Accounting Standards Codification (ASC) 845, formerly APB No. 29

C:4-65

John and Jean own 80% and 20%, respectively, of Plum Corporation stock. Thanks to their hard work, Plum's software sales have sky rocketed. In its first year of operation Plum's earnings were minimal, but four years later, Plum grossed \$10 million. Plum

compensated John and Jean as follows: John received a bonus of 76% of net profits and Jean received a bonus of 19% of net profits at the end of each year. Plum never paid any dividends. Can Plum deduct any or all of the “salaries” paid to John and Jean?

C:4-66

Sara owns 60% of Mayfield Corporation’s single class of stock. A group of five family members and three key employees own the remaining 40%. Mayfield is a calendar year taxpayer that uses the accrual method of accounting. Sara is a Mayfield officer and director and uses the cash method of accounting. During the period Year 1 through Year 3, Sara received the following amounts as salary and nontaxable fringe benefits from Mayfield: Year 1, \$160,000; Year 2, \$240,000; and Year 3, \$290,000. She earned these amounts evenly throughout the tax years in question. In Year 4, upon auditing Mayfield’s tax returns for Year 1 through Year 3, a revenue agent determined that reasonable compensation for Sara’s services for the three years in question is \$110,000, \$165,000, and \$175,000, respectively. The bylaws of Mayfield were amended on December 15, Year 2, to provide that:

Any payments made to an officer of the corporation, including salary, commissions, bonuses, other forms of compensation, interest, rent, or travel and entertainment expenses incurred, and which shall be disallowed in whole or in part as a deductible expense by the Internal Revenue Service, shall be reimbursed by such officer to the corporation to the full extent of such disallowance.

Following the disallowance of \$240,000 of the total salary expense, the board of directors met and requested that Sara reimburse Mayfield for the portion of her salary deemed to be excessive. Because of the large amount of money involved, the board of directors approved an installment plan whereby Sara would repay the \$240,000 in five annual installments of \$48,000 each over the period Year 5 through Year 9. The corporation would not charge Sara interest on the unpaid balance of \$240,000. Prepare a memorandum for your tax manager explaining what salary and fringe benefits are taxable to Sara in the period Year 1 through Year 3 and what reimbursements Sara can deduct during the period Year 5 through Year 9.