

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. Kenny Merinoff and his son, John, own all outstanding stock of Flamingo Corporation. Both John and Kenny are officers in the corporation and, together with their uncle, Ira, comprise the entire board of directors. Flamingo uses the cash method of accounting and has a calendar year-end. In late 2006, the board of directors adopted the following legally enforceable resolution (agreed to in writing by each of the officers):

Salary payments made to an officer of the corporation that shall be disallowed in whole or in part as a deductible expense for Federal income tax purposes shall be reimbursed by such officer to the corporation to the full extent of the disallowance. It shall be the duty of the board of directors to enforce payment of each such amount.

In 2010, Flamingo paid Kenny \$800,000 in compensation. John received \$650,000. On an audit in late 2011, the IRS found the compensation of both officers to be excessive. It disallowed deductions for \$400,000 of the payment to Kenny and \$350,000 of the payment to John. The IRS recharacterized the disallowed payments as constructive dividends. Complying with the resolution by the board of directors, both Kenny and John repaid the disallowed compensation to Flamingo Corporation in 2012. John and Kenny have asked you to determine how their repayments should be treated for tax purposes. John is still working as a highly compensated executive for Flamingo, while Kenny is retired and living off his savings. Prepare a memo for your firm's client files describing the results of your research.

Partial list of research aids:

§ 1341.

Vincent E. Oswald, 49 T.C. 645 (1968).

Research Problem 2. Oriole Corporation wholly owns Canary Corporation, which was formed six years ago with the transfer of several assets and a substantial amount of cash. Oriole's basis in the Canary stock is \$11.5 million. Since it was formed, Canary has been a very successful manufacturing company and currently has accumulated E & P of \$8 million. The company's principal assets are property, plant, and equipment (worth \$11 million) and cash and marketable securities of \$8.5 million, for a total fair market value of \$19.5 million.

Oriole and Canary are members of an affiliated group and have made the election under § 243(b) to entitle Oriole to a 100% dividends received deduction. From a strategic perspective, Oriole is no longer interested in manufacturing and is considering a sale of Canary. In anticipation of a sale in the next year or two, the management of Oriole has contacted you for advice. If Canary is sold outright, Oriole will have a capital gain of \$8 million (\$19.5 million fair market value less a basis of \$11.5 million). As an alternative, taxes on a future sale would be minimized if Canary first pays Oriole an \$8 million dividend equal to its E & P. With the 100% dividends received deduction, the payment would be tax-free to Oriole. Subsequent to the dividend payment, Canary can be sold for its remaining value of \$11.5 million (\$11 million in property, plant, and equipment plus \$500,000 in cash), resulting in no gain or loss to Oriole.

- Prepare a letter to Louise Jones, the president of Oriole Corporation, describing the results of the proposed plan. Oriole's address is 974 State Street, La Crosse, WI 53786.
- Prepare a memo for your firm's client files.

Partial list of research aids:

Waterman Steamship Corp. v. Comm., 70-2 USTC ¶9154, 26 AFTR 2d 70-5185, 430 F.2d 1185 (CA-5, 1970).