Taxation of Corporations and their Shareholders

Documents for
Lecture on Chapter 7

Part 1. Dividends and other distributions
Part 2. Stock Redemptions

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Taxation of Corporate Distributions [Sec. 301-318, 336(b)]

			["Corporation" distributes property, received by "stockholder."]
301	a		Distribution of **property** [§ 317(a)] is treated as described in subsection (c).
	b	1	**Amount of distribution is money plus FMV of property other than cash.**
		2	Amount of distribution is reduced by debt on property (to be paid by shareholder).
		3	FMV of property is determined on the date of distribution.
	c		**If section 316(a) applies,**
		1	**Amount that is a dividend under Sec. 316 (from E&P) is included in income.**
		2	**Amount that is NOT a dividend under Sec. 316 (from E&P) reduces basis.**
		3	**If return of capital distribution exceeds basis, the excess is gain on sale.**
	d		**Basis for property [received under §301(a)] is the FMV of the property.**
317			**What is Property (in a distribution under Sec. 301)?**
317	a		**Property:** money, securities, other property, but not stock of distributing corporation.
316			**Dividend Defined (Dividend is out of E&P).**
316	a		**Under this Subtitle, "dividend" means a distribution of property to shareholders.**
		1	**Out of E&P accumulated after February 28, 1913.**
		2	Out of E&P accumulated during the taxable year (not considering the distribution).
			Every distribution is made out of most recently accumulated E&P (tricky?).
311			**Gain of Loss for Corp. Distributing Appreciated Property**
311	a		**No** gain or **loss** - corporate distribution of stock or property - not in liquidation.
	b		**Exception - gain is recognized on distribution of "appreciated" property, as if sold (as if property were sold at FMV).**
		1	Rule similar to Sec. 336(a) applies when there is debt on property distributed-Next.
336			**What is FMV where debt exceeds FMV?**
336	b		FMV of property distributed is not less than debt on property - debt that is transferred to shareholder with the property (to be paid by stockholder).
312			**Earnings and Profits [E&P]**
			Code does not state this, but you generally start with taxable income & make adjustments to arrive at E&P.
			GAAP income is adjusted to get taxable income. Many of those adjustments are reversed - move from taxable income to E&P (actually more like GAAP).
	a		Reduce by amount of distribution - (1) cash, (2) debt of corporation tramsferred to stockholder (debt payable to stockholder) and (3) adjusted basis of property.
	b		[However] If distribution includes appreciated property - increase E&P by gain recognized by the corporation and decrease E&P by FMV of property distributed
	k		Must use straight-line depreciation method to compute E&P.
	n		Adjust taxable income to reflect economic gain or loss.
		3	No amortization under Section 248, when computing E&P.
		4	No LIFO, when computing E&P.
		5	No Installment sales method, when computing E&P.
		6	No completed contract method for long-term contracts, when computing E&P.

Corporate Distributions to Stockholder. [§301, §316, §317]

Ms. Rich started Rich Corporation in 2010, with an investment of $600,000.

Rich Corporation- Balance Sheet. 12-31-2017

Cash		$6,000,000	
Investment in ATT Stock (value: $500,000)		$200,000	
Other Assets- Building, etc. (value $3,500,000)		$800,000	
Total book value of assets			$7,000,000
Debt		$5,000,000	
Common Stock (Owner's Investment)	$600,000		
Retained Earnings (Also E & P)	$1,400,000	$2,000,000	
Total Book Value of Debt and Equity			$7,000,000
Total Fair Market Value of All Corporate Assets			$10,000,000

Each case is independent. Owner only chooses one transaction.

Case 1. Distribution does not exceed balance in Earnings & Profits.

On 12-31-2016, Ms. Rich takes a distribution of: **$1,000,000**

How dividend income is reported on Ms. Rich?

What is her basis in Rich Corp. stock after the distribution?

What is the balance in E&P after this distribution?

Case 2. Distribution exceeds balance in Earnings and Profits.

On 12-31-2016, Ms. Rich takes a distribution of: **$1,700,000**

How dividend income is reported on Ms. Rich?

What is her basis in Rich Corp. stock after the distribution?

Case 3. Distribution exceeds E&P and Stock Basis.

On 12-31-2016, Ms. Rich takes a distribution of: **$2,500,000**

How dividend income is reported on Ms. Rich?

How much of the distribution is a return of basis?

How much capital gain does she report?

What is her basis in Rich Corp. stock after the distribution?

Case 4. Distribution of appreciated property. §311

On 12-31-2016, Ms. Rich takes a distribution of:

ATT Stock. The corporation's basis in the stock was: **$200,000**

ATT Stock. The Fair Market Value of the stock was: **$500,000**

How much gain is recognized by the corporation?

How much dividend income is recognized by Ms. Rich?

What is her basis in the ATT Stock she received?

What is her basis in Rich stock after the distribution?

What is the balance in E&P after this distribution?

Case 5. Impact if Rich Corp. issues a 10% stock dividend? **[§305]**

Case 6. Impact if Rich Corp. buys 10% of her stock for $500,000? **[§302]**

Tax law for Property Distributions from a Corporation to a Shareholder

Subchapter C provides guidelines and rules for determining the tax status of distributions from a C corporation to its shareholders.

When corporation distributes property to persons **in their capacity as shareholders** without receiving any property or services in return, the shareholder must determine if the amount received is a dividend. [§ 301(a), (c)(1)]

Distributing corporation recognizes gain (but not loss) on a distribution of property other than cash in a dividend distribution. [§ 311(a), (b)]

Basic Tax Rules for Stock Dividends.

General rule: a shareholder does not include a stock dividend in income. [§ 305(a)]

Basis of the "new" stock received is computed by allocating basis from the existing stock based on relative fair market value. [§ 307(a)]

Holding period of the new stock includes the holding period of the existing stock on which the new stock was distributed. [§ 1223(4)]

Non-pro rata stock dividends usually are treated as taxable dividends to the recipient.

Compute Corporation's Earnings and Profits.

A dividend is any distribution of property made by a corporation to its shareholders out of its current or accumulated E&P. [§ 316(a)(1), (2)]

"Earnings and profits" is the tax equivalent of financial accounting "retained earnings." [The computations can be very different.]

Corporation keeps two E&P accounts: Current E&P and Accumulated E&P (from earlier years). [§ 316(a)(1), (2)]

IRC and related regulations list four types of adjustments that a corporation must make to its taxable income to compute current E&P:

(1) Inclusion of income that is excluded from taxable income. [Reg. § 1.312-6(b)]
(2) Disallow certain expenses that are deducted in computing taxable income.
(3) Deduct certain expenses that are excluded from computation of taxable income. [§ 312(n)(7)]
(4) Defer deductions or accelerate income due to separate accounting methods required for E&P purposes. [§ 312(k), (n)(5), (6), etc.]

Calculate Shareholder's Dividend Amount.

Shareholder's **dividend amount** (included in gross income) is the sum of **cash** received plus **FMV of property** (other than cash) **received, less any liabilities** assumed by shareholder. [§ 301(b)(1)]

Gross income of stockholder includes dividends [§61. Reg. §1.61-9]

Impact of Distribution on Corporate E&P.

A corporation reduces its E&P by the amount of cash distributed, the E&P basis of unappreciated property distributed, and the fair market value of appreciated property distributed, net of any liability assumed by the shareholders.

A "Constructive Dividend" to a Shareholder.

A transaction between a shareholder and a corporation that does not take the form of a dividend may be treated by the IRS as a constructive dividend. Examples include:

- Unreasonable compensation paid to shareholder/ employees.
- Bargain lease or uncompensated use of corporate property by a shareholder.
- Excess purchase/lease price paid to shareholder.
- "Loans" to a shareholder who has no intent to repay the loan.
- Corporate payments on shareholder's behalf.
- Illegal diversions of corporate income to stockholders.

Corporation Receiving a Dividend

Corporate shareholder – Div-Received-Deduction (70%, 80%, or 100%) [§ 243(a), (c)(1)]

With Consolidated Tax Return, Dividend Income (by parent) and Dividend Paid (by sub) are eliminated in the consolidating work paper.

Dividend of appreciated property to an affiliate**:** recognition of gain is deferred until property is sold to "outsider." [Reg. §1.1502-13(f)]
[Like deferral of gains on intercompany sales, etc.]

A Dozen Important Concepts from Chapter 7 (2016 is the first year)
This is a quick start problem. You may want to consult rules on later pages.

A corporation earns GAAP net income before income taxes of **$100,000.**

If GAAP net income includes municipal interest of $10,000,

adjust GAAP net income to get taxable income of $90,000.

"Earnings and Profits" are often about equal to GAAP retained earnings.

Example, do not include municipal bond interest in gross income,

but include it when computing earnings and profits "income."

Earnings and profits is a measure of your ability to pay ***"taxable"*** *dividends .*

Mun. bond interest income provides cash -can be used to pay dividend . Etc.

[Sec.312, also Reg.]

CASE. Joe owned a delivery truck.

(Cost $40,000. Accumulated depreciation $25,000. Value of truck was $28,000).

Joe organized a J Corp.

Joe invested the truck & received all of the JCorp. stock (1,000 shares). [Sec. 351].

Federal corporate income tax rate is a flat rate of 40%.

There is no state income tax. No book-tax adjustments.

These facts are used in independent cases below.

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1. Does Joe report sec. 1245 recapture income on this exchange? [Sec. 1245(b)(3)]

2. What is Joe's basis in corporate stock? [Section 358(a)(1)]

3. In 2016, JCorp had net income of $0 and taxable income of $0.
In 2016, JCorp paid income tax of $0.
Jcorp. made a distribution of $5,000 to Joe on Dec. 31, 2016. What does Joe report?

Dividend		**Return of Capital**		**Capital Gain**		**End. stock basis**	
Sec. 317(a), 316(a)(1)		Sec. 301(c)(1), (2)		Sec. 301(c)(3)		Sec. 301(c)(2)	

4. (Ignore no. 3 above) In 2016, JCorp had taxable income of $50,000.
In 2016, JCorp paid income tax of $20,000. After-tax income was $30,000.
JCorp made a distribution of $25,000 on 12-31-2016. What does Joe report?

Dividend		**Return of Capital**		**Capital Gain**		**End. stock basis**	

5. (Ignore no. 3 & 4 above) In 2016, JCorp had taxable income of $50,000.
In 2016, Jcorp paid income tax of $20,000. After-tax income was $30,000 ($2,500 per month).
JCorp made a distribution of $25,000 on 1-31-2016.

Is his div. income only $2,500 (one month of earnings)?		**Dividend Amt.**	

Look at entire year to determine if dividends are covered by current E&P.

6. In 2016, after-tax income: $30,000.
JCorp made distributions of $25,000 on May 31 and $25,000 on December 31, 2016.

How much of May 31 payment of $25,000 is dividend income for Joe?	

7. JCorp had net loss of ($100,000) in 2016 and net income of $20,000 in 2017.

Joe received cash dist. of $10,000 on Dec. 31, 2017. Joe's div. income for 2017?	

8. JCorp had taxable income in 2016 of $50,000 (and income tax of $20,000).
JCorp had a net loss of ($60,000) in 2017

Joe received a cash dist. of $40,000 on May 31, 2017. Joe's div. income for 2017?	

9. In 2016, JCorp had NIBT and taxable income of $50,000 and paid income tax of $20,000.
JCorp made a cash distribution of $47,000 on Dec. 31, 2016. What does Joe report?

Dividend		**Return of Capital**		**Capital Gain**		**End. stock basis**	

10. In 2016, JCorp had NIBTand taxable income of $50,000 and paid income tax of $20,000.
JCorp distributed (to Joe) land on 12-31-2016 (JCorp's basis: $22,000. FMV was $28,000.)
JCorp did make any other distribution. What does Joe report?

Dividend		**Return of Capital**		**Capital Gain**		**End. stock basis**	

How much gain does JCorp report? Sec. 311(b)(1)		**What is Joe's land basis?**	

Impact on Earnings and Profits? Sec. 312(a), (b)

11. Assume land in No. 10 is subject to debt of $5,000.
How much dividend does Joe report? [Sec. 301(b)(2)]

Joe received value of $28,000, less debt assumed-$5,000, equals div. income of:	

12. In 2016, JCorp had NIBT and taxable income of $50,000 and paid income tax of $20,000.
In 2016, JCorp distributed 500 shares of JCorp common stock to Joe. [Sec. 305, 307]
Stock had a total value of $10,000. This is the only distribution to Joe. What does Joe report?

Dividend Income		**Ending basis per share of common stock**	

SEC. 301. Distributions of Property

(a) In General. Except as otherwise provided in this chapter, a distribution of **property** (as defined in **section 317(a))** made by a corporation to a shareholder with respect to its stock shall be **treated the manner** provided in subsection (c).

(b) Amount Distributed.

(1) General rule. For purposes of this section, the amount of any distribution shall be the amount of **money received, plus the fair market value of other property received.**

(2) Reduction for liabilities. The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) Determination of fair market value. For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) Amount Taxable.

In the case of a distribution to which subsection (a) applies-

(1) Amount constituting dividend. That portion which is a dividend (as defined in section 316) shall be **included in gross income**.

(2) Amount applied against basis. That portion of the distribution which is not a dividend shall be **applied against and reduce the adjusted basis** of the stock.

(3) Amount in excess of basis.

(A) In general. Except as provided in subparagraph (B), that **portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange** of property.

(B) Distributions out of increase in value accrued before March 1, 1913. That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

(d) Basis. The basis of property received in a distribution to which subsection (a) applies shall be the **fair market value** of such property.

SEC. 317.Other Definitions

(a) Property. For purposes of this part, the term "property" means money, securities, and any other **property;** except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) Redemption of Stock. For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

SEC. 316. Dividend Defined

(a) General Rule. For purposes of this subtitle, the term **"dividend" means** any distribution of property made by a corporation to its shareholders—

(1) **out of its earnings and profits** accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and **from the most recently accumulated earnings and profits.** To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

SEC. 311. Taxability of Corporation on Distribution

(a) General Rule. Except as provided in subsection (b), no gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to its stock of—

(1) its stock (or rights to acquire its stock), or

(2) property.

(b) Distributions of Appreciated Property.

(1) In general. If-

(A) a **corporation distributes property** (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and

(B) the **fair market value of such property exceeds its adjusted basis** (in the hands of the distributing corporation), **then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.**

(2) Treatment of liabilities. Rules similar to the rules of section 336(b) shall apply for purposes of this subsection.

(3) Special rule for certain distributions of partnership or trust interests. If the property distributed consists of an interest in a partnership or trust, the Secretary may by regulations provide that the amount of the gain recognized under paragraph (1) shall be computed without regard to any loss attributable to property contributed to the partnership or trust for the principal purpose of recognizing such loss on the distribution.

Sec. 312. Effect on Earnings and Profits

(a) General Rule. Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, **the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of-**

(1) the amount of money,

(2) the principal amount of the obligations of such corporation … and

(3) the adjusted basis of the other property, so distributed.

(b) Distributions of Appreciated Property. On the distribution by a corporation, with respect to its stock, of any property (other than an obligation of such corporation) the **fair market value of which exceeds the adjusted basis** thereof—

(1) the earnings and profits of the corporation shall be **increased by the amount of such excess,** and

(2) subsection (a)(3) shall be applied by **substituting "fair market value" for "adjusted basis"**. For purposes of this subsection and subsection (a), the adjusted basis of any property is its adjusted basis as determined for purposes of computing earnings and profits.

(c) Adjustments for Liabilities. In making the adjustments to earnings and profits .. under subsection (a) or (b), proper adjustment shall be made for-

(1) the amount of any liability to which the property distributed is subject, and

(2) the amount of any liability of the corporation assumed by a shareholder in connection with the distribution.

(d) Certain Distributions of Stock, Securities

(1) In general. The distribution to a distributee by or on behalf of a **corporation of its stock or securities**, shall not be considered a distribution of earnings.…

(B) if the distribution was not subject to tax in the hands of such distributee by reason of section 305(a).

(f) Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions. Omitted

(g) Earnings and Profits—Increase in Value Accrued Before March 1, 1913. Omitted

(h) Allocation in Certain Corporate Separations and Reorganizations. Omitted

(k) Effect of Depreciation on Earnings and Profits

(1) General rule. For purposes of computing the earnings and profits of a corporation for any taxable year beginning after June 30, 1972, the allowance for depreciation (and amortization, if any) shall be deemed to be the amount … allowable for such year if the straight line method of depreciation had been used **….**

(3) Exception for tangible property.

(A) In general. Except as provided in subparagraph (B), in the case of tangible property to which **section 168 applies, the adjustment to earnings and profits for depreciation for any taxable year shall be determined under the alternative depreciation system**.

(l) Discharge of Indebtedness Income. Omitted

(m) No Adjustment for Interest Paid on Certain Registration-Required Obligations Not in Registered Form.

(n) Adjustments to Earnings and Profits To More Accurately Reflect Economic Gain and Loss.
For purposes of computing the earnings and profits of a corporation, the following adjustments shall be made:

(1) Construction period carrying charges. Omitted

(4) LIFO inventory adjustments

(A) In general. Earnings and profits shall be increased or decreased by the amount of any increase or decrease in the LIFO recapture amount as of the close of each taxable year; …

(B) LIFO recapture amount. For purposes of this paragraph, the term "LIFO recapture amount" means the amount (if any) by which-
(i) the inventory amount of the inventory assets under the first-in, first-out method …. Exceeds
(ii) the inventory amount of such assets under the LIFO method. Omitted

(5) Installment sales. In the case of any installment sale, earnings and profits shall be computed **as if the corporation did not use the installment method.**

(6) Completed contract method of accounting.
In … earnings and profits shall be computed as if such taxpayer used the percentage of completion method of accounting.

(7) Redemptions. If a corporation distributes amounts in a redemption to which section 302(a) or 303 applies, the part of such distribution which is properly chargeable to earnings and profits shall be an amount which is not in excess of the **ratable share of the earnings and profits of such corporation accumulated after February 28, 1913, attributable to the stock so redeemed.**

Regulation §1.312-4. Internal Revenue Service, Examples of adjustments provided in section 312(c)

Reg. § 1.312-4 does not reflect recent law changes. For details, see ¶15,607.01.

Note from Instructor. This regulation was issued with T.D. 6152 on December 2, 1955, and has not been updated since that time. Since that time, Section 312 has been updated with the addition of Sec. 312(b). You will note that the example(s) below is (are) inconsistent with the current version of Section 312(b). **This is an example of the trap you can encounter if you do not take note of the fact that a regulation is older than the related code section.**

The adjustments provided in section 312(c) may be illustrated by the following examples:

Example (1). On December 2, 1954, Corporation X distributed to its sole shareholder, A, an individual, as a dividend in kind a vacant lot which was not an inventory asset.

On that date, the lot had
a **fair market value** of $5,000 and
was subject to a **mortgage** of $2,000.
The **adjusted basis of the lot** was $3,100.
The amount of the earnings and profits was $10,000.

The **amount of the dividend** received by A is **$3,000** ($5,000, the fair market value, less $2,000, the amount of the mortgage) and
the **reduction in the earnings and profits** of Corporation X is **$1,100** ($3,100, the basis, less $2,000, the amount of mortgage).

Example (2). The facts are the same as in example (1) above with the exception that the amount of the mortgage to which the property was subject was $4,000. The amount of the dividend received by A is $1,000, and there is no reduction in the earnings and profits of the corporation as a result of the distribution (disregarding such reduction as may result from an increase in tax to Corporation X because of gain resulting from distribution). There is a gain of $900 recognized to Corporation X, the difference between the basis of the property ($3,100) and the amount of the mortgage ($4,000), under section 311(c) and an increase in earnings and profits of $900.

Regulation §1.312-6. Internal Revenue Service, Earnings and profits

Reg. § 1.312-6 does not reflect recent law changes. For details, see ¶15,611.01.

(Also issued in 1955)

(a) …

(b) Among the items entering into the computation of corporate earnings and profits for a particular period are **all income exempted by statute,** income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts.

Gains and losses within the purview of section ..

Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

Compute Earnings & Profits

Davis Corporation, an accrual method taxpayer,
Davis had accumulated E & P of $100,000 as of December 31, 2015.
For the 2016 tax year, Davis' books and records reflect the following:

Sales		$700,000
Cost of sales	$400,000	
Municipal bond interest		2,000
Compensation	100,000	
Meals and entertainment (Gross)	20,000	
Payroll taxes, and Miscellaneous Expense	140,000	
Subtotal	660,000	702,000
Net Income before taxes	42,000	
Total	$702,000	$702,000

Davis does not have any carryover of losses, deductions or credits to this year.
The company does not qualify for any credits in the current year.
You may ignore the impact of state income taxes.
What is the amount of accumulated E & P as of December 31, 2016?
a. $134,500 b. $187,000 c. $250,000 d. $313,000 e. None of these

First Compute Taxable Income & Income Tax	Debit	Credits
Sales		$700,000
Cost of sales	$400,000	
Municipal bond interest		2,000
Compensation	100,000	
Meals and entertainment (Gross)	20,000	
Payroll taxes, & Misc. Expense	140,000	
Subtotal	660,000	702,000
Net Income (GAAP) before taxes	42,000	
Add: one half of entertainment	10,000	
Deduct: municipal bond interest	(2,000)	
Taxable income	50,000	
Income Tax	7,500	

Compute Earnings & Profits (Similar to Retained Earnings)		
Taxable Income		50,000
Tax-exempt income	Add	2,000
Federal income taxes	Subtract	(7,500)
Nondeductible entertainment	Subtract	(10,000)
Equals: Current Earnings and Profits		34,500
Add: Accumulated E&P at first of year		100,000
Total		134,500
Less: Dividends paid		
Earnings and Profits at End of Year		134,500

Note: E & P is reduced by nondeductible expenses that reduce dividend paying ability - such as non-deductible entertainment expense.

Dividend Example generated by Class Discussion

Case 1			
Begin. basis in stock of sole stockholder	$17,000		
Begin. Earnings and Profits	$0		
Current Earnings and Profits	$30,000		
	June 30		Dec. 31
Amount of Cash Distribution	$25,000		$25,000
Dividend		Average	
Return of Capital		FIFO	
Capital Gain			
Ending basis			
Case 2			
Begin. basis in stock of sole stockholder	$16,000		
Begin. Earnings and Profits	$12,000		
Current Earnings and Profits	$30,000		
	June 30		Dec. 31
Amount of Cash Distribution	$25,000		$25,000
Dividend - Current E & P		Average	
Dividend - Accumulated E & P		FIFO	
Return of Capital			
Capital Gain			
Ending basis			

Please complete the following set of independent cases. Calendar year Company.
In all cases, the stockholders have substantial basis (basis is not a issue).

	Accumulated E&P (beginning of year	Current E & P	Cash Distribution End of Year	Dividend Income	Return of Capital
Case A	($200,000)	$70,000	$130,000		
Case B	$150,000	($120,000)	$210,000		
Case C	$90,000	$70,000	$150,000		
Case D	$120,000	($60,000)	$130,000		
Case E	$120,000	($60,000)	$130,000		

Case E is same as Case D, except distribution of
$130,000 is made on June 30, not December 31.

Compute Earnings and Profits

Taxable income	
Plus: Income excluded from taxable income but included in E&P	
Tax-exempt interest income	
Life insurance proceeds where the corporation is 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: Deferred Income that is included in E&P in the current year	
Deferred gain on installment sales is included in E&P in year of sale	
Plus or minus: Income & deduction items that ARE recomputed when computing E&P	
Income on long-term contracts must be based on percentage of completion method rather than completed contract method	
Depreciation on personal and real property must be based on:	
The straight-line method for property other than MACRS or ACRS property	
Straight-line ACRS calculation with extended recovery period for ACRS property	
The alternative depreciation system for MACRS property	
Excess of percentage depletion claimed over cost depletion	
Plus: Deductions that reduce taxable income but do not affect E&P	
Dividends-received deduction	
Carryovers (NOL, charity, and capital loss) used in current year	
Minus: Non-Deductible Expenses and Losses that reduce E&P	
Federal income taxes	
Life insurance premiums where the corporation is the beneficiary	
Excess capital losses that are not deductible in current year	
Excess charitable contributions that are not deductible in current year	
Expenses related to production of tax-exempt income	
Nondeductible losses on sales to related parties	
Nondeductible penalties and fines	
Nondeductible political contributions and lobbying expenses	
Equals: Current Earnings and Profits	
Add: Accumulated Earnings & Profits at end of Prior Year	
Subtotal	
Less: Dividends paid in Current Year	
Earning and Profits at end of Current Year	

Dividend Example generated by Class Discussion

Case 1

Begin. basis in stock of sole stockholder	$17,000		
Begin. Earnings and Profits	$0		
Current Earnings and Profits	$30,000		
	June 30		Dec. 31
Amount of Cash Distribution	$25,000		$25,000
Dividend	$15,000	Average	$15,000
Return of Capital	$10,000	FIFO	$7,000
Capital Gain			$3,000
Ending basis			$0

Case 2

Begin. basis in stock of sole stockholder	$16,000		
Begin. Earnings and Profits	$12,000		
Current Earnings and Profits	$30,000		
	June 30		Dec. 31
Amount of Cash Distribution	$25,000		$25,000
Dividend - Current E & P	$15,000	Average	$15,000
Dividend - Accumulated E & P	$10,000	FIFO	$2,000
Return of Capital	$0		$8,000
Capital Gain			
Ending basis			$8,000

Please complete the following set of independent cases. Calendar year Company.
In all cases, the stockholders have substantial basis (basis is not a issue).

	Accumulated E&P (beginning of year	Current E & P	Cash Distribution End of Year	Dividend Income	Return of Capital
Case A	($200,000)	$70,000	$130,000	$70,000	$60,000
Case B	$150,000	($120,000)	$210,000	$30,000	$180,000
Case C	$90,000	$70,000	$150,000	$150,000	$0
Case D	$120,000	($60,000)	$130,000	$60,000	$70,000
Case E	$120,000	($60,000)	$130,000	$90,000	$40,000

Case E is same as Case D, except distribution of
$130,000 is made on June 30, not December 31.

Distributions	Reg. §1.312-1 (old)		Reg. §1.312-4 (old)		
	Case 1	Case 2	Case 3	Case 4	
Earn. & Profits balance	$12,500	$20,000	$10,000	$10,000	
Land:					
Land FMV:	$10,000	$10,000	$5,000	$5,000	
Land Basis:	$5,000	$15,000	$3,100	$3,100	
(footnote)Debt on Land:	$0	$0	$2,000	$4,000	
Impact on Stockholder:					
Amount of Dividend:					§301(b)(1)
Land basis for stockholder					§301(d)
Corp. Taxable Income:					
Loss recognized by distributing Corp.					§311(a)
Gain recognized by distributing Corp.					§311(b)(1)
Earnings and Profits:					
Reduction in E&P from distribution					§312(a)(3), (b)
Adjust for debt					§312(c)
Net Reduction in E&P					
Increase in E&P from gain on distribution					§312(b)(1)

Footnote: Debt is assumed by Stockholder
These cases ignore the impact of paying income tax on gain recognized.

Regulation, §1.312-3.,Internal Revenue Service, Liabilities (Out of date)
Reg. §1.312–3 does not reflect P.L. 94–455, P.L. 99–514 or P.L. 95–628.
The amount of any reductions in earnings and profits described in section 312(a) or (b) shall be
(a) reduced by the amount of any liability to which the property distributed was subject and by the amount of any other liability of the corporation assumed by the shareholder in connection with such distribution, and
(b) increased by amount of gain recognized to the corporation under section 311(b), (c), or (d)….

Distributions	Reg. §1.312-1 (old)		Reg. §1.312-4 (old)		
	Case 1	Case 2	Case 3	Case 4	
Earn. & Profits balance	$12,500	$20,000	$10,000	$10,000	
Land:					
Land FMV:	$10,000	$10,000	$5,000	$5,000	
Land Basis:	$5,000	$15,000	$3,100	$3,100	
(footnote)Debt on Land:	$0	$0	$2,000	$4,000	
Impact on Stockholder:					
Amount of Dividend:	$10,000	$10,000	$3,000	$1,000	§301(b)(1)
Land basis for stockholder	$10,000	$10,000	$5,000	$5,000	§301(d)
Corp. Taxable Income:					
Loss recognized by distributing Corp.	N/A	$0	N/A	N/A	§311(a)
Gain recognized by distributing Corp.	$5,000	N/A	$1,900	$1,900	§311(b)(1)
Earnings and Profits:					
Reduction in E&P from distribution	($10,000)	($15,000)	($5,000)	($5,000)	§312(a)(3), (b)
Adjust for debt			$2,000	$4,000	§312(c)
Net Reduction in E&P			($3,000)	($1,000)	
Increase in E&P from gain on distribution	$5,000	$0	$1,900	$1,900	§312(b)(1)

Footnote: Debt is assumed by Stockholder
These cases ignore the impact of paying income tax on gain recognized.

Regulation, §1.312-3.,Internal Revenue Service, Liabilities (Out of date)

Reg. §1.312–3 does not reflect P.L. 94–455, P.L. 99–514 or P.L. 95–628.

The amount of any reductions in earnings and profits described in section 312(a) or (b) shall be
(a) reduced by the amount of any liability to which the property distributed was subject and by the amount of any other liability of the corporation assumed by the shareholder in connection with such distribution, and
(b) increased by the amount of gain recognized to the corporation under section 311(b), (c), or (d)….

A Dozen Important Concepts from Chapter 7 (2016 is the first year)

A corporation earns GAAP net income before income taxes of **$100,000.** If GAAP net income includes municipal interest of $10,000, adjust GAAP net income to get taxable income of **$90,000.**
"Earnings and Profits" is a type retained earnings that is often about equal to GAAP retained earnings.
*Example, do not include municipal bond interest in gross income, but include it when computing earnings and profits "income." Earnings and profits is a measure of your ability to pay **"taxable"** dividends*.
Municipal bond interest income provides cash that can be used to pay dividends . Etc. [Sec.312, also Reg.]

CASE. Joe owned a delivery truck. (Cost $40,000. Accumulated depreciation $25,000. Its value was $28,000).
Joe organized a J Corporation (Jcorp). He invested the truck in return for all of stock (1,000 shares). [Sec. 351].
Federal corporate income tax rate is a flat rate of 40%. There is no state income tax. No book-tax adjustments.
These facts are used in independent cases below, with variations in amount of income or loss, or distribution.

1. Does Joe report sec. 1245 depreciation recapture income on this exchange? [Sec. 1245(b)(3)] — **No**

2. What is Joe's basis in corporate stock after he organizes the corporation? [Section 358(a)(1)] — **$15,000**

3. In 2016, JCorp had net income of $0 and taxable income of $0. JCorp paid income tax of $0.
Corporation made a distribution of $5,000 to Joe on December 31, 2016. What does Joe report?

Dividend	$0	Return of Capital	$5,000	Capital Gain	$0	Ending stock basis	$10,000
Sec. 317(a), 316(a)(1)		Sec. 301(c)(1), (2)		Sec. 301(c)(3)		Sec. 301(c)(2)	

4. In 2016, JCorp had taxable income of $50,000 and paid income tax of $20,000. (Ignore no. 3 above)
After-tax income was $30,000. JCorp made a distribution of $25,000 on 12-31-2016. What does Joe report?

Dividend	$25,000	Return of Capital	$0	Capital Gain	$0	Ending stock basis	$15,000

5. In 2016, JCorp had taxable income of $50,000 and paid income tax of $20,000. (Ignore no. 3 & 4 above)
After-tax income was $30,000 ($2,500 per month). JCorp made a distribution of $25,000 on 1-31-2016.

Is his dividend income only $2,500 (for one month of earnings)?	No	Dividend amount	$25,000

Look at entire year to determine if dividends are covered by current E&P. [Same as answer for no. 5 above.]

6. In 2016, after-tax income: $30,000. JCorp made distributions of $25,000 on May 31 and $25,000 on Dec. 31.

How much of May 31 payment of $25,000 is dividend income for Joe?	$15,000

7. JCorp had net loss of ($100,000) in 2016 and net income of $20,000 in 2017.
Joe received cash distribution of $10,000 on Dec. 31, 2017. Joe's dividend income for 2017? — **$10,000**

8. JCorp had taxable income in 2016 of $50,000 (and income tax of $20,000) and net loss of ($60,000) in 2017.
Joe received a cash distribution of $40,000 on May 31, 2017. Joe's dividend income for 2017? — **$5,000**

9. In 2016, JCorp had net income before tax and taxable income of $50,000 and paid income tax of $20,000.
JCorp made a cash distribution of $47,000 on December 31, 2016. What does Joe report?

Dividend	$30,000	Return of Capital	$15,000	Capital Gain	$2,000	Ending stock basis	$0

10. In 2016, JCorp had net income and taxable income of $50,000 and paid income tax of $20,000.
JCorp distributed (to Joe) land on 12-31-2016 (JCorp's basis was $22,000 and FMV was $28,000.)
JCorp did make any other distribution. What does Joe report?

Dividend	$28,000	Return of Capital	$0	Capital Gain	$0	Ending stock basis	$15,000

How much gain does JCorp report? Sec. 311(b)(1)	$6,000	What is Joe's land basis?	$28,000

Impact on Earnings and Profits? Sec. 312(a), (b)

11. Assume land in No. 10 is subject to debt of $5,000. How much dividend does Joe report? [Sec. 301(b)(2)]

Joe received value of $28,000, less debt he assumes of $5,000, equals dividend income of:	$23,000

12. In 2016, JCorp had net income and taxable income of $50,000 and paid income tax of $20,000.
In 2016, JCorp distributed 500 shares of JCorp common stock to Joe. [Sec. 305, 307]
The stock had a total value of $10,000. This is the only distribution to Joe. What does Joe report?

Dividend Income	$0	Ending basis per share of common stock	$10

Non-Liquidating Distribution by C Corporation

Joe owns 100% of stock of a corp. Joe has a basis of $20,000 in the entity. (Sound right?)
Joe take a "current" distribution of $30,000 in cash. E&P balance is $6,000

	Basis	FMV
Cash	$40,000	$40,000
Machinery	10,000	20,000
Land	20,000	30,000
Total	$70,000	$90,000
Liabilities	$44,000	
Stock ($10 par-2,000 shares)	20,000	
Retained Earnings (Also E & P)	$6,000	
Total	$70,000	

Step		
1.	Joe's basis in the stock before distribution	$20,000
2.	Balance in E & P before dividend	$6,000
3.	Amount of Cash distributed to Joe	$30,000
4.	Joe's dividend income - E&P-Sec. 301(c)	
5.	Excess of Distribution over E & P	
6.	Joe's adjusted basis in stock before distribution	
7.	Joe's tax-free return of capital Sec. 301(c)(2)	
8.	Joe's capital gain. Sec. 301(c)(3)	
9.	Joe's ending basis in stock of corporation	

	C Corporation (Distributions- Sec. 301, 312(a),(b), 316, 317)			
1	Sec. 301 covers "property" distributions, defined in 317.	301	a	
	Sec. 317, "property" is everything except dividend of stock in the corporation	317		
2	A distribution is a dividend -- to the extent it is from E&P.	301	c	1
	Dividend is included in income.	61	a	7
3	Distribution in excess of E&P is not a dividend.	301	c	2
4	Distribution in excess of E&P reduces stock basis. (Tax-free until basis is recovered)	301	c	2
5	Distribution in excess of E&P and stock basis, is capital gain.	301	c	3
	Stock basis is only reduced under Sec. 301(c)(2)			

What if Joe takes a 5% stock dividend (no cash dividend)- receives 100 additional shares?

Sec. 305. Joe's gross income?

Sec. 307. Basis per share?

Instead of cash or stock distribution, Joe takes a distribution of all of the land.

What is the impact of the distribution on the Corporation and on Joe?

Sec. 311(b). Corp. recognizes?

Sec. 301(b). Joe's distribution-Amount?

Sec. 301(c). Joe's dividend income?

Sec. 301(d). Joe's Basis in land?

Sec. 301(b)(2). What if Joe assumes debt-$4,000?

The basic rules above are also applicable for S corportions (Sec. 1368).
If S corporation does not have E&P (from C years), start with step 6 above.
If S corp. DOES have E&P (from C years), that may cause regular dividend.
The basic rules above also appy for partnerships (Sec. 731 & 733)
Partnership does not have E&P. Start with step 6. Focus is on "Cash" distribution.

Non-Liquidating Distribution by C Corporation

Joe owns 100% of stock of a corp. Joe has a basis of $20,000 in the entity. (Sound right?)
Joe take a "current" distribution of $30,000 in cash. E&P balance is $6,000

	Basis	FMV
Cash	$40,000	$40,000
Machinery	10,000	20,000
Land	20,000	30,000
Total	$70,000	$90,000
Liabilities	$44,000	
Stock ($10 par-2,000 shares)	20,000	
Retained Earnings (Also E & P)	$6,000	
Total	$70,000	

Step		
1.	Joe's basis in the stock before distribution	$20,000
2.	Balance in E & P before dividend	$6,000
3.	Amount of Cash distributed to Joe	$30,000
4.	Joe's dividend income - E&P-Sec. 301(c)	$6,000
5.	Excess of Distribution over E & P	$24,000
6.	Joe's adjusted basis in stock before distribution	$20,000
7.	Joe's tax-free return of capital Sec. 301(c)(2)	$20,000
8.	Joe's capital gain. Sec. 301(c)(3)	$4,000
9.	Joe's ending basis in stock of corporation	$0

	C Corporation (Distributions- Sec. 301, 312(a),(b), 316, 317)			
1	Sec. 301 covers "property" distributions, defined in 317.	301	a	
	Under Sec. 317, "property" is everything except dividend of stock in the corporation	317		
2	A distribution is a dividend -- to the extent it is from E&P.	301	c	1
	Dividend is included in income.	61	a	7
3	Distribution in excess of E&P is not a dividend.	301	c	2
4	Distribution in excess of E&P reduces stock basis. (Tax-free until basis is recovered)	301	c	2
5	Distribution in excess of E&P and stock basis, is capital gain.	301	c	3
	Stock basis is only reduced under Sec. 301(c)(2)			

What if Joe takes a 5% stock dividend (no cash dividend)- receives 100 additional shares?

Sec. 305. Joe's gross income?	Gross income generally does not include a stock dividend.	
Sec. 307. Basis per share?	Basis allocated among 2,100 shares. Basis per share?	$9.52

Instead of cash or stock distribution, Joe takes a distribution of all of the land.

What is the impact of the distribution on the Corporation and on Joe?

Sec. 311(b). Corp. recognizes?	Corp. has gain of $10,000, as if corp. sold the land at its FMV.
Sec. 301(b). Joe's distribution-Amount?	The amount of Joe's distribution is FMV of the property ($30,000)
Sec. 301(c). Joe's dividend income?	Joe's distribution is dividend income to extent it is from E & P.
Sec. 301(d). Joe's Basis in land?	Joe's basis in land is its FMV on date of distribution ($30,000).
Sec. 301(b)(2). What if Joe assumes debt-$4,000?	Amt of distribution: $26,000. Basis-$30,000

The basic rules above are also applicable for S corportions (Sec. 1368).
If S corporation does not have E&P (from C years), start with step 6 above.
If S corp. DOES have E&P (from C years), that may cause regular dividend.
The basic rules above also appy for partnerships (Sec. 731 & 733)
Partnership does not have E&P. Start with step 6. Focus is on "Cash" distribution.

No.	Corporations: Earnings & Profits and Dividends - Tab 1			Problem	Sec.	Sub		
1	Basic Information for Betty Jane (BJ) and her new "C" corporation (BJ Corp.)				1011			
	On 1-1-16, BJ invested these assets in BJ Corp. & received 100% of the stock.				1012			
			Basis	FMV				
	[BJ received 1,000 shares of common stock]	Land	$60,000	$100,000				
		Other assets	$200,000	$200,000				
		Total assets	$260,000	$300,000	351	a		
2	Corporation had income and expense on Form 1120 for 2016:							
		Revenue from repair services		$400,000	61			
	[Not a Personal Service Corporation]	Salary to BJ (a reasonable salary)		($100,000)	162			
		Other expenses, except taxes		($235,000)	162			
		North Carolina Income Taxes		($5,000)	164			
		Subtotal (taxable income)		$60,000	63			
		Federal Income Taxes		($10,000)	11			
		Net income after taxes		$50,000				
		Interest on NC bonds ($20,000)		$20,000	1.312	-	6	b
		Earn. and profits at end of first year?		$70,000				
	Note: the following cases are independent, except where noted.							
3	Amount of distributions to shareholder by BJ Corp. in 2016			$0				
	What is BJ's basis in her BJ Corp. stock at 12-31-16? [Sec. 1012]				358	a	1	
	"Total income" BJ reports from BJ Corporation for 2016?				61			
	Balance in BJ Corporation's Earnings & Profits at 12-31-2016?				312			
	Would life insurance proceeds ($10,000) increase E&P?				1.312	-	6	b
	May you reduce corporate E&P by adopting accelerated deprec.?				312	k		
4	In 2016, BJ received a distribution from BJ Corp. of CASH:			$40,000				
	Dividend income BJ reports from BJ Corp. for 2016?			$40,000	301	c	1	
	Does it matter whether dividend was paid in January or Dec?							
	What federal tax rate applies to her dividend income for 2016?				1	h	3	B
	Balance in BJ Corp's Earnings & Profits at 12-31-2016?				312	a	1	
	BJ's basis in her BJ Corporation stock at 12-31-2016?				1012			
5	BJ received distribution of 100 shares of corp. stock with value:			$30,000				
	Dividend income BJ reports as result of receiving the stock?				305			
	BJ's TOTAL BASIS in 100 shares received from BJCorp?		1.307-1(a)		307			
	Increase or decrease in E&P as a result of the stock dividend?				1.312	-	1	d

No.		Corporations: Earnings & Profits and Dividends - Tab 1		Solution	Sec.	Sub		
1		Basic Information for Betty Jane (BJ) and her new "C" corporation (BJ Corp.)			1011			
		On 1-1-16, BJ invested these assets in BJ Corp. & received 100% of the stock.			1012			
			Basis	FMV				
	[BJ received	Land	$60,000	$100,000				
	1,000 shares of	Other assets	$200,000	$200,000				
	common stock]	Total assets	$260,000	$300,000	351	a		
2		Corporation had income and expense on Form 1120 for 2016:						
		Revenue from repair services		$400,000	61			
	[Not a	Salary to BJ (a reasonable salary)		($100,000)	162			
	Personal	Other expenses, except taxes		($235,000)	162			
	Service	North Carolina Income Taxes		($5,000)	164			
	Corporation]	Subtotal (taxable income)		$60,000	63			
		Federal Income Taxes		($10,000)	11			
		Net income after taxes		$50,000				
		Interest on NC bonds ($20,000)		$20,000	1.312	-	6	b
		Earn. and profits at end of first year?		$70,000				
		Note: the following cases are independent, except where noted.						
3		Amount of distributions to shareholder by BJ Corp. in 2016		$0				
		What is BJ's basis in her BJ Corp. stock at 12-31-14? [Sec. 1012]		$260,000	358	a	1	
		"Total income" BJ reports from BJ Corporation for 2016?		$100,000	61			
		Balance in BJ Corporation's Earnings & Profits at 12-31-2016?		$70,000	312			
		Would life insurance proceeds ($10,000) increase E&P?		Yes	1.312	-	6	b
		May you reduce corporate E&P by adopting accelerated deprec.?		No	312	k		
4		In 2016, BJ received a distribution from BJ Corp. of CASH:		$40,000				
		Dividend income BJ reports from BJ Corp. for 2016?		$40,000	301	c	1	
		Does it matter whether dividend was paid in January or Dec?		No				
		What federal tax rate applies to her dividend income for 2016?		15%	1	h	3	B
		Balance in BJ Corp's Earnings & Profits at 12-31-2016?		$30,000	312	a	1	
		BJ's basis in her BJ Corporation stock at 12-31-2016?		$260,000	1012			
5		BJ received distribution of 100 shares of corp. stock with value:		$30,000				
		Dividend income BJ reports as result of receiving the stock?		$0	305			
		BJ's TOTAL BASIS in 100 shares received from BJCorp?	1.307-1(a)	$23,636	307			
		Increase or decrease in E&P as a result of the stock dividend?		$0	1.312	-	1	d

No.	Corporations: Earnings & Profits and Dividends - Tab 2		Problem	Sec.	Sub		
1	On 1-1-2016, BJ invested assets in a C corp. & received 100% of the stock.			1012			
	BJ's basis in corp. stock was same as her basis in assets invested: $260,000.						
	See Preceding Tab in this Excel file (No. 1 and 2) for complete details.						
	Note: the following cases are independent, except where noted.						
6	In 2016, BJ received distribution from BJ Corp. of CASH:		$80,000				
	Amount of distribution to BJ that is a return of capital?			301	c	2	
	Dividend income BJ reports from corporation for 2016?			316	a		
	What is BJ's basis in her corporate stock at 12-31-2016?			301	c	2	
	What is "total" taxable income for Corporation for 2016?						
7a	In 2016, BJ received distribution from BJ Corp. of CASH:		$30,000	301	c	1	
	In 2016, BJ received a distribution of LAND.	Corp. Basis	$12,000				
	In 2016, land distributed to BJ had FMV:	FMV	$25,000				
	Dividend income BJ reports for distribution of land?			301	b	1	
	Total dividend income BJ reports from Corp. for 2016?			301	c	1	
	BJ's BASIS in the LAND received from BJ Corporation?			301	d		
	Increase in corp. taxable income from land distribution?			311	b		
	Impact on E&P from distribution of land?	From Gain		312	b	1	
	[Do not consider related income tax on gain.]	Distribution		312	a	3,	b2
7b	In 2016, BJ received a distribution of LAND.	Corp. Basis	$12,000				
	In 2016, land distributed to BJ had FMV:	FMV	$25,000				
	Amount of debt on land that BJ Corp. assumes:	Mortgage	$4,000				
	Dividend income BJ reports from land distribution?	301(b)(1)		301	b	2	
	BJ's basis in the land received from BJ Corporation?			301	d		
	Impact on E&P from distribution of land?	From Gain		312	b	&	c
	[Do not consider income tax on gain.]	Distribution		312	a	3,	b2
8	See No. 7a. BJ's income from purchase if she buys the land for $15,000?			1.301	-	1	j
9	In 2016, BJ takes a distribution of an asset.	Corp. Basis	$12,000				
	In 2016, land distributed to BJ had FMV:	FMV	$9,000				
	BJ Corp's recognized gain or loss distribution?			311	a		
	Amount of the reduction in BJ Corporation's E&P?			312	a	3	
	Dividend income BJ reports for distribution of this asset?			301	b	1	
	BJ's basis in the asset received from BJ Corporation?			301	d		
	What is BJ's basis in her BJ Corporation stock at 12-31-2016?						

No.	Corporations: Earnings & Profits and Dividends - Tab 2		Solution	Sec.	Sub		
1	On 1-1-2016, BJ invested assets in a C corp. & received 100% of the stock.			1012			
	BJ's basis in corp. stock was same as her basis in assets invested: $260,000.						
	See Preceding Tab in this Excel file (No. 1 and 2) for complete details.						
	Note: the following cases are independent, except where noted.						
6	In 2016, BJ received distribution from BJ Corp. of CASH:		$80,000				
	Amount of distribution to BJ that is a return of capital?		$10,000	301	c	2	
	Dividend income BJ reports from corporation for 2016?		$70,000	316	a		
	What is BJ's basis in her corporate stock at 12-31-2016?		$250,000	301	c	2	
	What is "total" taxable income for Corporation for 2016?		$60,000				
7a	In 2016, BJ received distribution from BJ Corp. of CASH:		$30,000	301	c	1	
	In 2016, BJ received a distribution of LAND.	Corp. Basis	$12,000				
	In 2016, land distributed to BJ had FMV:	FMV	$25,000				
	Dividend income BJ reports for distribution of land?		$25,000	301	b	1	
	Total dividend income BJ reports from Corp. for 2016?		$55,000	301	c	1	
	BJ's BASIS in the LAND received from BJ Corporation?		$25,000	301	d		
	Increase in corp. taxable income from land distribution?		$13,000	311	b		
	Impact on E&P from distribution of land?	From Gain	$13,000	312	b	1	
	[Do not consider related income tax on gain.]	Distribution	($25,000)	312	a	3,	b2
7b	In 2016, BJ received a distribution of LAND.	Corp. Basis	$12,000				
	In 2016, land distributed to BJ had FMV:	FMV	$25,000				
	Amount of debt on land that BJ Corp. assumes:	Mortgage	$4,000				
	Dividend income BJ reports from land distribution?	301(b)(1)	$21,000	301	b	2	
	BJ's basis in the land received from BJ Corporation?		$25,000	301	d		
	Impact on E&P from distribution of land?	From Gain	$9,000?	312	b	&	c
	[Do not consider income tax on gain.]	Distribution	($21,000)	312	a	3,	b2
8	See No. 7a. BJ's income from purchase if she buys the land for $15,000?			1.301	-	1	j
9	In 2016, BJ takes a distribution of an asset.	Corp. Basis	$12,000				
	In 2016, land distributed to BJ had FMV:	FMV	$9,000				
	BJ Corp's recognized gain or loss distribution?		$0	311	a		
	Amount of the reduction in BJ Corporation's E&P?		($12,000)	312	a	3	
	Dividend income BJ reports for distribution of this asset?		$9,000	301	b	1	
	BJ's basis in the asset received from BJ Corporation?		$9,000	301	d		
	What is BJ's basis in her BJ Corporation stock at 12-31-2016?		$260,000				

Homework for Chapter 7-Part 1. Dividends. (Part 2 covers redemptions)

Introduction – Compute E & P

1. Earnings and profits is a measure of:

a. After-tax income **b.** Dividend paying ability **c.** Liquidity

2. [§301, §316, §317] Client owns Local Corporation that is operated in a single location. **Ms. Rich** started the company many years ago with an investment of $500,000 and has owed all of the stock since that time.

Local Corporation- 12-31-2017

Cash	$2,000,000	
Other Assets- Building, etc. (value $6,000,000)	$3,000,000	
Total book value of assets		**$5,000,000**
Debt	$0	
Common Stock (Owner's Investment)	$500,000	
Retained Earnings (Also E & P)	$4,500,000	
Total Book Value of Debt and Equity		**$5,000,000**
Total Value of All Corporate Assets		$8,000,000

Ms. Rich takes a distribution of $1,000,000 in cash on 12-31-15.
How income or gain is reported on Ms. Rich's income tax return for this transaction?

a. $800,000 **b.** $500,000 **c.** $1,000,000 **d.** $0

3. [§301, §316, §317] **Ms. Frugal** owns Local Corporation. She started the company many years ago with an investment of $1,000,000 and has owed all of the stock since that time.

Local Corporation- 12-31-2017

Cash	$1,000,000	
Other Assets- Building, etc. (value $6,000,000)	$1,500,000	
Total book value of assets		**$2,500,000**
Debt	$0	
Common Stock (Owner's Investment)	$1,000,000	
Retained Earnings (Also E & P)	$500,000	
Total Book Value of Debt and Equity		**$1,500,000**
Total Value of All Corporate Assets		$7,000,000

Ms. Frugal takes a distribution of $800,000 in cash on 12-31-2017.
How income or gain is reported on Ms. Frugal's income tax return for this transaction?

a. $800,000 **b.** $500,000 **c.** $1,000,000 **d.** $0

4. [§301, §316, §317] On 1-1-2016, **Ernie** started Local Corporation (a C corp.).
Ernie paid $100,000 for 100% of the stock.
In 2016, Local had after-tax income of $40,000 and paid no dividend.
In 2017, Local had after-tax income of $40,000.
Current earnings and profits equal after-tax income for Local Corporation.
Local paid a dividend of $90,000 to Ernie on December 31, 2017.
How much dividend income does Ernie report for 2017?

a. $0.00 **b.** $40,000 **c.** $80,000 **d.** $90,000

5. [§312-not helpful here.] **Charlotte Corp.**, an accrual method taxpayer, had accumulated E&P of $100,000 as of December 31, 2015. For the 2016 tax year, Charlotte's books reflect the following:

Sales		$700,000
Cost of sales	$ 400,000	
Municipal bond interest		12,000
Compensation	100,000	
Meals and entertainment (Gross)	20,000	
Payroll taxes, and Miscellaneous Expense	140,000	
Subtotal	660,000	712,000
Net Income before taxes	52,000	
Total	$ 712,000	$712,000

Charlotte does not have any carryover of losses, deductions or credits to the current year. The company does not qualify for any credits in 2016. Consider the impact of federal income taxes for 2016, but ignore the impact of state income taxes. What is the amount of Charlotte Corporation's accumulated earnings and profits as of January 1, 2017?

a. $134,500 **b.** $144,500 **c.** $250,000 **d.** $313,000 **e.** Other Amount

6. [§312-not helpful here.] **Elite Corporation,** an accrual method taxpayer, had accumulated earnings and profits of $50,000 as of December 31, 2015.
For its 2016 tax year, Elite's books and records reflect the following:

Taxable income per return	$125,000
Tax-exempt interest received	2,500
Federal income taxes	32,000
Business meals in excess of 50% limitation	3,500
Charitable Contributions in excess of limitation (10%)	1,500

What is the amount of Elite's accumulated earnings and profits as of January 1, 2017?

a. $138,000 **b.** $138,500 **c.** $140,500 **d.** $145,000

Cash Distributions

7. [§301, §316, §317] The following information pertains to **Tahl Corp**.:

Accumulated earnings and profits at January 1, 2017	$120,000
Current earnings and profits for the year ended December 31, 2017	160,000
Cash distributions to individual stockholders during 2017	260,000

What is the total amount of distributions taxable as dividend income to Tahl's stockholders in 2017?

a. $360,000 **b.** $280,000 **c.** $160,000 **d.** $260,000 CPANov1995-Mod

8. [§301, §316, §317] **Ridge Corp.**, a calendar-year C corporation, made a nonliquidating cash distribution to its shareholders of $1,000,000 with respect to its stock.
At that time, Ridge's current and accumulated earnings and profits totaled $750,000.
Its total paid-in capital for tax purposes was $10,000,000.
Ridge had no corporate shareholders. Ridge's cash distribution

I. Was taxable as $750,000 in dividend income to its shareholders
II. Reduced its shareholders' adjusted bases in Ridge stock by $250,000

a. I only. **c.** II only. CPANov1995
b. Both I and II **d.** Neither I nor II

9. [Reg. §1.316 -1(e)] On January 1, 2017, **Ray Corp**., (a C corporation) had a $50,000 deficit in accumulated earnings and profits.
In 2017, Ray had current E&P of $10,000 and paid a $30,000 cash distribution to its only stockholder. The stockholder had a basis in her stock of $5,000 prior to the dividend.
What amount of the distribution is taxable as capital gain to Ray's stockholder?

a. $17,000 **b.** $20,000 **c.** $30,000 **d.** $15,000 CPA M-95-Modified

10. [Reg. §1.316-2(c)] Jason started a C Corporation on January 1, 2016.
Jason invested $100,000, and received all 1,000 shares of stock in the new corporation.
The corporation had after-tax income of $12,000 in 2016.
The corporation also had E&P of $12,000 at the end of 2016.
Jason expected to have more profitable operations in 2017, so he began a policy of paying cash dividends of $10,000 on the last day of each calendar quarter (March 31, etc.) of 2017.
After receiving a dividend of $10,000 on March 31 and another dividend of $10,000 on June 30, 2017, Jason sold all of his stock to an unrelated investor.
The new owner continued the policy of paying cash dividends on the last day of each quarter.
The corporation had after-tax income and E&P of $8,000 for 2017.
How much dividend income will Jason report for 2017 from this corporation?

a. $4,000 **b.** $8,000 **c.** $16,000 **d.** $20,000

11. [Reg. §1.316-2(c)] **Walnut, Inc**. is a C corporation which was started in January, 2017.
In 2017, Walnut, Inc. made a $5,000 distribution in the first month of each quarter (total $20,000 for year). In 2017, Walnut, Inc. had $150,000 in gross income and $140,000 in allowable expenses from ordinary business operations. Walnut, Inc. also received $5,000 in fully tax-exempt interest from state bonds. Walnut paid no income tax because it has sufficient tax credits. **Walnut's founder and 100% shareholder died in March, 2017.** His children inherited his stock and received the dividends for the last 3 quarters. What part of the first quarter distribution is a distribution of E&P (Dividend income)?

a. $5,000 **b.** $3,750 **c.** $2,500 **d.** $1,250 [IRS – 2004 Mod]

12. Corporation V, a calendar year C Corporation that began conducting business in 2003, had accumulated earnings and profits of $20,000 as of January 1, 2017.
On July 1, 2017, V distributed $30,000 in cash to Mr. Edwards, Corporation V's sole shareholder.
Corporation V had a $2,000 earnings and profits for 2017.
Mr. Edwards had an adjusted basis of $7,000 in his stock before the distribution.
What is the amount of Mr. Edwards' dividend income and capital gain as of the date of the distribution?

	Dividend Income	**Capital Gain**
a.	$20,000	$10,000
b.	$21,000	$2,000
c.	$22,000	$1,000
d.	$22,000	$0

13. Camden, Inc., a calendar year C corporation began conducting business in 2001. Camden had accumulated earnings and profits of $20,000 as of January 1, 2017. On October 1, 2017, Camden distributed $25,000 in cash to Beaufort, Camden's sole shareholder. Camden had a $20,000 **Deficit** in earnings and profits for 2017. Beaufort had an adjusted basis of $8,000 in his stock before the distribution. What is the amount of Beaufort's ordinary dividend income and capital gain as of the date of the distribution?

	Dividend Income	Capital Gain
a.	$ 0	$25,000
b.	$25,000	$ 0
c.	$ 5,000	$12,000
d.	$ 5,000	$ 8,000

14. Elk Corporation, a calendar year C corporation. It had accumulated earnings and profits of $60,000 as of January 1, 2017, the beginning of its tax year. Elk had an operating loss of $70,000 for the first 6 months of 2017, but had earnings and profits of $6,000 for the entire tax year 2017. Elk distributed $15,000 to its shareholders on July 1, 2017. What portion of the $15,000 distribution would be an ordinary dividend?

a. $15,000 **b.** $10,000 **c.** $6,000 **d.** $0

Non-Cash Property Distributions

15. [§311] **Bank Corp**., which had current and accumulated earnings and profits of $500,000. Bank made a nonliquidating distribution of property to its shareholders in the year as a dividend in kind. This property had an adjusted basis of $40,000 and a fair market value of $30,000 at the date of distribution. How much loss did Bank recognize on this distribution?

a. $30,000 **b.** $20,000 **c.** $10,000 **d.** $0 (CPAN94#51)

16. [§311, §301(b)(3)] On December 31, **Davidson Corp.** distributed to Ms. Smith (its sole shareholder), cash and a parcel of land (as a dividend). On the date of the distribution, this info was available:

Cash distributed	$10,000
Adjusted basis of land distributed	6,000
Fair Market Value of land	6,000

For the year ended December 31, Davidson had current and accumulated E&P of $30,000, without regard to the dividend distribution. Smith's basis in his corporate stock was $5,000 before the distribution. How much income or gain is recognized by the corporation and Ms. Smith, the shareholder?

	Davidson Corporation	Ms. Smith
a.	$0	$10,000
b.	$0	$16,000
c.	$6,000	$6,000
d.	$6,000	$16,000
e.	Other	Other

17. [§311, §301(b)(3)] Morris Corporation has $100,000 positive current E&P to cover any distributions. It distributes land with a fair market value of $30,000 and adjusted basis of $10,000 to its sole shareholder, Mary, who has $70,000 basis in her Morris Corp. stock. <u>This is not a liquidation or redemption.</u> Which statement below best describes the tax consequences to the Morris Corporation and to stockholder, Mary?

- **a.** Morris will recognize gain of $20,000 and Mary a taxable dividend of $20,000.
- **b.** Morris will recognize gain of $20,000 and Mary a taxable dividend of $30,000.
- **c.** Morris will recognize gain of $20,000 and Mary will have a non-taxable return of capital reducing her basis by $30,000.
- **d.** None of the above.

18. [§311, §301(b)(3)] On December 31, Blue Corporation distributed to Mr. Smith (its sole shareholder), as a dividend in kind, a parcel of land that was not an inventory asset. On the date of the distribution, the following data were available:

Adjusted basis of land	$ 6,000
Fair Market Value of land	14,000

For the year ended December 31, Blue had current and accumulated earnings and profits of $30,000, without regard to the dividend distribution. Mr. Smith's basis in his corporate stock was $5,000 before the distribution.

How much income or gain is recognized by the corporation and Mr. Smith, the shareholder?

	Blue Corporation	**Mr. Smith**
a.	$0	$1,000
b.	$8,000	$6,000
c.	$6,000	$8,000
d.	$8,000	$14,000
e.	Other	Other

19. [§311(b)(2), §301(b)(2)] On December 31, Blue Corporation distributed to Mr. Smith (its sole shareholder), as a dividend in kind, a parcel of land. On the date of the distribution, the following data were available:

Adjusted basis of land	$ 6,000
Fair Market Value of land	14,000
Mortgage on land	5,000

For the year ended December 31, Blue had current and accumulated E&P of $30,000, without regard to the distribution. How much income is recognized by the corporation and by Mr. Smith?

	Blue Corporation	**Mr. Smith**
a.	$0	$1,000
b.	$8,000	$6,000
c.	$8,000	$9,000
d.	$8,000	$14,000
e.	Other	Other

20. [§311, §301(b)(2)] Rally Corporation distributed a sailboat to its sole shareholder, Ms. H. At the time of the distribution, the sailboat had a FMV of $175,000 and an adjusted basis to Rally of $150,000. The sailboat was subject to a loan of $190,000, which Ms. H assumed. What is the amount of Rally's gain or (loss) on the distribution?

a. ($15,000) **b.** $0 **c.** $25,000 **d.** $40,000 IRS-1995

Constructive Dividends

21. A business owner takes a large salary from her very profitable corporation. If the IRS determines that the salary is unreasonably large and treats it as in substance a dividend, it will propose?

a. Increase the gross income of owner **b.** Increase the gross income of corporation
c. Decrease the expense of the corporation **d.** Add a surtax to tax return of owner

Stock Dividends

22. [§301, §317(a), 305] The Board of Directors of CYZ Corp. votes to issue two shares of stock for each share held as a stock dividend to shareholders.
Before the dividend, Cheryl owns 100 shares of CYZ Corp. stock that she purchased for $12 per share. She receives 200 new shares as a result of the dividend.
Now, she owns 300 shares. What is the basis of each share of her stock after the dividend?

a. $12.00 **b.** $8.00 **c.** $4.00 **d.** None of these

23. [§301, §317(a), 305] Sue bought 100 shares of Smith Corp. common stock in 1990, for $6,600. On June 30, 2008, she received a 10% stock dividend from Smith Corp. (ten shares of Smith Corp. common stock). Sue did not have an option of receiving cash rather than stock. On September 1, 2017, she sold 50 shares of Smith Corp. common stock for $5,000. As a result of these transactions she should report gain for 2017 of:

a. 0 **b.** $2,000 **c.** $3,000 **d.** $5,000 **e.** Other Amount

24. [§301, §317(a), 305] A corporation with common stock outstanding declares a nontaxable dividend payable in rights to subscribe to common stock. Each right entitles the holder to purchase one share of stock for $90. One right is issued for every two shares of stock owned. Fred owns 400 shares of stock purchased two years ago for $15,000. At the time of the distribution of the rights, the market value of the common stock is $100 per share, and the market value of the rights is $8 per right. Fred does not allocate his original stock basis to the rights. Fred receives 200 rights. He exercises 100 rights and sells the remaining 100 rights three months later for $9 per right. The sale of the rights results in:

a. No gain or loss **b.** Long-term capital gain of $900
c. Short-term capital gain of $900

Taxation of Corporations and their Shareholders

Documents for Lecture on Chapter 7

Part 2. Stock Redemptions

UNC Charlotte MACC Program
Turner School of Accountancy

March 1, 2017

Stock Redemptions

Tax Impact of Stock Redemptions [§317]

If the transaction is treated as a **dividend**, the shareholder has gross income in an amount equal to the cash and fair market value of other property received to the extent of the corporation's E&P. [§ 302(d)], [§ 301(c)]

The basis of the property received is its fair market value. [§ 301(d)]

If a redemption is treated as an **exchange,** the shareholder computes gain or loss by comparing the amount realized (money and property received) with the tax basis of the stock surrendered. [§ 302(a)]

Treated as payment in exchange for stock.

Character of the gain or loss is capital.

Basis of noncash property received is FMV.

Holding period of the property received begins at the date of receipt.

Meaningful Change in Ownership

The IRC treats redemptions as exchanges in transactions in which the shareholder's ownership interest in the corporation has been "meaningfully" reduced relative to other shareholders as a result of the redemption.

There are three change-in-stock-ownership tests that entitle a shareholder to exchange treatment in a redemption.

1. **Not Essentially Equivalent**
   A redemption will be treated as an exchange if the redemption is "not essentially equivalent to a dividend:"
   This is a facts and circumstances determination (subjective).
   To satisfy this requirement, the courts or IRS must conclude that there has been a "meaningful" reduction in the shareholder's ownership interest in the corporation as a result of the redemption (usually below 50 percent stock ownership). [§ 302(b)(1)]

2. **Substantially Disproportionate**
   The IRC states that a redemption will be treated as an exchange if the redemption is **"substantially disproportionate** with respect to the shareholder;" defined as follows: [§ 302(b)(2)]

   Immediately after the exchange the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

   The shareholder's percentage ownership of voting stock after the redemption is less than 80 percent of his or her percentage ownership before the redemption.

   The shareholder's percentage ownership of the aggregate fair market value of the corporation's common stock (voting and nonvoting) after the redemption is less than 80 percent of his or her percentage ownership before the redemption.

3. **Complete Redemption.** a redemption will be treated as an exchange if the redemption is in "complete redemption of all of the stock of the corporation owned by the shareholder:" [§ 302(b)(3)]

Stock Attribution Rules [§ 302(c), § 318]
In determining whether the change-in-stock-ownership tests are met, each shareholder's percentage change in ownership in the corporation before and after a redemption must take into account constructive ownership (attribution) rules. The attribution rules cause stock owned by other persons to be treated as owned by (attributed to) the shareholder for purposes of determining whether the shareholder has met any of the change-in-stock-ownership tests to receive exchange treatment.

Family attribution. Individuals are treated as owning the shares of stock owned by their spouse, children, grandchildren, and parents.

Attribution from entities to owners or beneficiaries.

Partners are deemed to own a pro rata share of their partnership's stock holdings (i.e., a partner who has a 10 percent interest in a partnership is deemed to own 10 percent of any stock owned by the partnership).

Shareholders are deemed to own a pro rata share of their corporation's stock holdings, but only if they own at least 50 percent of the value of the corporation's stock.

Attribution from owners or beneficiaries to entities.

Partnerships are deemed to own 100 percent of stock owned by partners (i.e., a partnership is deemed to own 100 percent of stock owned by a 10 percent partner)

Attribution to a corporation only applies to shareholders owning 50 percent or more of the value of the corporation's stock.

Option attribution. A person having an option to purchase stock is deemed to own the stock that the option entitles the person to purchase.

Waive Family Attribution. Shareholders can waive family attribution rules in a complete redemption of their stock if conditions are met.

The shareholder has not retained a prohibited interest in the corporation immediately after the exchange (e.g., as a shareholder, employee, director, officer, or consultant).

The shareholder does not acquire a prohibited interest within 10 years after the redemption, unless by inheritance (the 10-year look-forward rule).

The shareholder agrees to notify the IRS district director within 30 days if she acquires a prohibited interest within 10 years (sign a triple i agreement).

Redemption to Pay Death Taxes

Exchange treatment is given to certain redemptions to pay death taxes. [§ 302(b)(3)]

Redemption through Related Corp.

Ms. Rich owns all stock in Corp. A and all stock in Corp. B. She has Corp. B to buy some of her Corp. A stock. That transaction is treated as a redemption of Corp. A stock by Corp. A. [§ 304]

Effect of Redemption on E&P.

If the redemption is treated as a dividend by the shareholder, the corporation generally reduces its E&P by the cash distributed and the fair market value of other property distributed. [§ 312(a)]

If the redemption is treated as an exchange by the shareholder, corporation reduces E&P at date of distribution by percentage of stock redeemed (i.e., if 50 percent of the stock is redeemed, E&P is reduced by 50 percent), not to exceed the FMV of property distributed. [§ 312(n)(7)]

Partial Liquidation of a Corporation

For a distribution to be a partial liquidation, it must either be "not essentially equivalent to a dividend" (as determined at the corporate level, not the shareholder level) or is the result of the termination of a "qualified trade or business:" [§ 302(b)(4)]

The tax treatment of a distribution received in partial liquidation of a corporation depends on the identity of the shareholder receiving it.

All noncorporate shareholders get exchange treatment.

All corporate shareholders are subject to the stock redemption change in ownership rules, which usually results in dividend treatment because partial liquidations are almost always pro rata distributions.

The following outline is for next chapter

Complete liquidation of a corporation

The liquidating corporation recognizes gain and (usually) loss on a liquidating distribution of property **to** its shareholders. [§ 336(a)]
(See exception below for parent liquidating a sub.)

Shareholders receiving a distribution in complete liquidation of their corporation generally recognize gain and loss on the exchange of their stock for the corporate property. [§ 331(a)] (See exception below for parent liquidating a subsidiary.)

Tax basis of each asset received by the shareholder (from a liquidating corporation) generally equals the asset's FMV on date of the distribution. [§ 334(a)]

The liquidating corporation cannot deduct losses on property distributed in three situations (omitted).

Liquidation of a Subsidiary

Liquidating subsidiary corporation does not recognize gain or loss on a liquidating distribution of property to a corporate shareholder that owns 80 percent or more of the liquidating corporation.
[§ 337] [If § 332 applies]

A parent corporation does not recognize gain or loss on the receipt of a property distribution from a liquidating subsidiary, if the parent owns 80 percent or more of the liquidating corporation. [§ 332(a)]

The tax basis of each asset received by an 80 percent or more corporate shareholder in a tax-deferred complete liquidation carries over from the liquidating corporation to the parent. [§ 334(b)]

Stock Redemptions

Let's begin with a simple example

On January 1, 2015, you invest $100,000 to start a new corporation, and you receive 10,000 shares of $10 par stock. You own 100% of the company.
The company has after-tax income of $20,000 in 2015. The balance sheet is shown below.

	January 1	December 31
Cash and other assets	**$100,000**	**$120,000**
Common stock (10,000 shares)	$100,000	$100,000
Retained earnings		$20,000
Total owner equity	**$100,000**	**$120,000**

Assume your stock has a value equal to book value, which is $120,000 ($12 per share).

You would like to receive $12,000. You have 3 options:

(1) Receive a distribution of cash of **$12,000** from the company,

(2) Sell 1,000 shares to a neighbor (who is not related to you) at a price of $12 per share (total **$12,000** selling price), or

(3) Sell 1,000 shares **to your corporation** at a price of $12 per share (total **$12,000**).

With option no. 1 above, you will **report $12,000 of dividend income**. (Section 301)
You continue to own 10,000 shares and their basis is unchanged at $100,000. (That is your original cost.)

With option no. 2 above, you will **report a capital gain of $2,000**.
Your remaining total basis in the 9,000 shares will be $90,000. You no longer own 100% of the company

Will the results for option no. 3 above be the same as the results with option 2? Not for you!

You could **report $2,000 capital gain if you owned fewer shares before the redemption** (for example, you owned only 2,000 shares, and an unrelated individual owned the other 8,000 shares before your redemption.)

However, you actually owned all of the 10,000 outstanding shares before the redemption. You have no meaningful reduction in ownership as a result of the redemption – you still own 100% of the company (you now own all 9,000 outstanding shares outstanding after your stock redemption).

Further explanation of Option no. 3. You are stuck with Code Section 301.

You are a stockholder receiving cash from the corporation in your role as a stockholder.
Section 301 states that this transaction gives you dividend income of $12,000 – even though you are technically selling stock (with a cost of $10,000 and a value of $12,000) at a selling price of $12,000 and a profit of only $2,000. You don't report a capital gain of $2,000.

You report dividend income of $12,000.

The basis in the stock sold to the corporation is added to the basis of the other stock you own.
Reg. 1.302-2(c) example 1. Your basis in the remaining 9,000 shares are equal to the basis that you previously had for 10,000 shares.

Section 302 gives me 4 ways to escape from Section 301

You can get exchange treatment under Section 302, meaning that you can report a gain or loss, not a dividend. Section 303 gives you another way to avoid section 301, but section 303 involves you paying a high price for the tax savings.

Four types of redemptions qualify for sale treatment, not dividend treatment under Sec. 302.

1. Redemptions not essentially equivalent to a dividend. Sec. 302(b)(1).
   Case law suggests that you avoid trying to prove this.
2. Substantially disproportionate redemptions. Sec. 302(b)(2).
   (Know this one: 80%, 50% rules.)
3. Termination of shareholder's interest. Sec. 302(b)(3).
4. Redemption from non-corporate shareholder in partial liquidation.

And another one in Section 303 – redemption to pay death taxes.

Please study sections listed above.

Note that constructive ownership rules [Section 318(a)] apply. Section 302(c)(1). If you own 50% the company and a related party (spouse, trust, or company you own, etc.) owns the other 50% – you are considered to own 100% of the company. If you sell your 50% back to the company - you may think you own 0% - you constructively own 100% of the company even though you have no direct ownership.

You can avoid the constructive ownership rules when applying the exception under Sec. 302(b)(3).
To avoid these rules, you have to "get lost." Get out of the company and stay out.
See Sec. 302(c)(2).

Please read the following one-page (Michael Cerone) later in these lecture materials.
Please be prepared to explain the issues and the court's conclusion in the Cerone case.

This case illustrates the trap that you must avoid (for your client, your employer, your friend)

Distribution of property other than cash to a stockholder in redemption of stock. (non-liquidating distribution)

If the corporation **distributes appreciated property** in redemption of its stock, the corporation reports a gain as if the property is sold (Sec. 311). If the property has a value that is less than basis, no loss is reported by corporation making the distribution (Section 311) (rule is different for liquidations).

Key Questions - Non-liquidating Distribution as a Stock Redemption:

1. How much income, gain or loss is reported by the stockholder receiving the non-cash property?
2. What is the basis of the non-cash property received by the individual?
3. What is the impact on the taxable income of the corporation?
4. What is the impact on earnings and profits of the corporation?

How do answers to the questions above change if the non-cash property has a basis to the corporation in excess of its FMV (it is not appreciated "gain" property, it is depreciated "loss" property).

					Taxation of Corporate Distributions [Sec. 301-318, 336(b)]
1	301	a			Distribution of property [§ 317(a)] is treated as described in subsection (c)
6		b	1		Amount of distribution is money plus FMV of property
7			2		Amount of distribution is reduced by debt on property distributed
8			3		FMV is determined in date of distribution
		c			If section 316(a) applies,
9			1		The amount that is a dividend under Sec. 316 (from E&P) is included in income.
10			2		The amount that is NOT dividend under Sec. 316 (from E&P) reduces basis.
11			3	A	If return of capital distribution exceeds basis, the excess is gain on sale.
12		d			Basis is FMV for property received under §301(a)
	317				**What is Property (in a distribution under Sec. 301)?**
2	317	a			Property includes money, securities, other property, but not stock in the corp.
	316				**Dividend Defined (Dividend is out of E&P).**
3	316	a			Under this Subtitle, "dividend" means a distribution of property to shareholders
4			1		Out of E&P accumulated after February 28, 1913.
5			2		Out of E&P accumulated during the taxable year (not considering the distribution).
					Every distribution is made out of the most recently accumulated E&P.
	311				**Gain of Loss for Corp. Distributing Appreciated Property**
	311	a			No gain or loss - corporate distribution of stock or property - not in liquidation.
		b			Exception - gain is recognized on distribution of appreciated property, as if sold.
			1		Rule similar to Sec. 336(a) applies when there is debt on the property distributed.
	336				**What is FMV where debt exceeds FMV?**
	336	b			FMV of property distributed is not less than debt on property - debt that is transferred.
13	312				**Earnings and Profits**
					Code does not state this, but generally start with taxable income & adjust
14		a			Reduce by amount of distribution - cash, debt of corp. and adjusted basis of property.
		b			If distribution includes appreciated property - increase by gain and decrease by FMV
		k			Must use straight-line depreciation method to compute E&P.
		n			Adjust to reflect economic gain or loss.
			3		No amortization under Section 248
			4		No LIFO
			5		No Installment sales method
			6		No completed contract method for long-term contracts

302			**Stock redemption - sale of stock by stockholder?**
	a		**<u>Section 301 (dividend treatment) applies except for these 4 redemptions.</u>**
	b	**1**	Redemption not essentially equivalent to a dividend
		2	Substantially disproportionate distribution
		3	Termination of shareholder's interest [can avoid stock attribution rules (c)(2)
		4	Redemption in a partial liquidation
	c	**1**	Stock attribution rules apply. (c)(2) Attribution rules may NOT apply for (c)(3)
303			**Stock redemption - to pay death taxes**
			Exchange treatment - redemption to pay Death Taxes, Funeral Exp., Administrative Exp.
304			**Stock redemption - through related corpoation**
			Can't play this game.

305		**Stock Dividend - Generally not a taxable Dividend**
	b	But not if stockholder has option to receive cash rather than stock, etc.
306		**Stock Dividend etc. - Limit on bailout of earnings**
		Limits on payment of a tax-free stock dividend and then having it redeemed - LTCG
307		**Basis of stock or stock rights received in a distribution**
		Generally, allocate basis of old stock between (1) old stock and (2) new stock received.
318		**Constructive Ownership of Stock**
		You are treated as owning stock actually owed by your family members, your businesses, etc.

Lecture Problems on Corporate Stock Redemptions

Corporate shareholders like dividend income.
Individual shareholders like capital gains. Why? Sec. 243

Case				Code	
	Basic Case. Bob organzed LOCAL Corporation				
	He rceived all shares of LOCAL Corp. stock.	Shares	2,000		
	Bob's cost per share is $40	Cost/Share	$40		
	Bob's total cost of 200 shares of stock	Total Cost	$80,000		
	Local Corporation has earnings and profits	E&P balance	$100,000		
Case	**Independent Cases. (These are not liquidating distributions.)**			Code	
1	**LOCAL Corp. makes cash distribution of $50,000 to Bob. Bob reports:**	Div. Income		301	c
2	**Bob sells 1,000 shares of LOCAL to a stranger for $50 per share**	Shares	1,000		
	Bob's selling price per share	Price/share	$50		
	Bob's total selling price for 1,000 shares	Selling Price	$50,000		
	Total cost of shares Bob sold (1,000 shares at cost of $40 per share)	Cost	$40,000		
	Gain Bob reports gain on sale of 1,000 shares	Gain		1001	
3	**LOCAL Corp. redeems 1,000 of Bob's shares. LOCAL pays Bob $50 per share.**				
	Number of shares redeemed	Shares	1,000		
	Redemption price per share	Price/share	$50		
	Total amount Bob received for 1,000 shares	Total			
3a	**Assume Bob qualifies for "Exchange Treatment."**				
	Local pays Bob $50,000 - LOCAL buys Bob's stock.				
	Number of shares redeemed from Bob	Shares	1,000		
	Bob's cost per share	Cost/share	$40		
	Total cost of shares sold	Cost	$40,000		
	Total price for 1,000 shares at $50 per share.	Selling Price	$50,000		
	Bob reports capital gain on sale of his stock.	Cap. Gain		302	b
3b	**Assume Bob qualifies for "Dividend Treatment."**			301	
	Local pays $50,000 for half of Bob's stock.			301	a
	Bob reports dividend income.	Div. Income			
	Actually, Bob cannot qualify for exchange treatment under the tax law.				
	Name five types of redemptions that get exchange treatment.	Sec. 302(b) and 303		302	b

Lecture Problems on Corporate Stock Redemptions

Corporate shareholders like dividend income.
Individual shareholders like capital gains. Why? Sec. 243

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Case	**Independent Cases. (These are not liquidating distributions.)**			**Code**	
1	**LOCAL Corp. makes cash distribution**			301	c
	of $50,000 to Bob. Bob reports:	Div. Income	$50,000		
2	**Bob sells 1,000 shares of LOCAL**				
	to a stranger for $50 per share	Shares	1,000		
	Bob's selling price per share	Price/share	$50		
	Bob's total selling price for 1,000 shares	Selling Price	$50,000		
	Total cost of shares Bob sold (1,000 shares at cost of $40 per share)	Cost	$40,000		
	Gain Bob reports gain on sale of 1,000 shares	Gain	$10,000	1001	
3	**LOCAL Corp. redeems 1,000 of Bob's**				
	shares. LOCAL pays Bob $50 per share.				
	Number of shares redeemed	Shares	1,000		
	Redemption price per share	Price/share	$50		
	Total amount Bob received for 1,000 shares	Total	$50,000		
3a	**Assume Bob qualifies for "Exchange Treatment."**				
	Local pays Bob $50,000 - LOCAL buys Bob's stock.				
	Number of shares redeemed from Bob	Shares	1,000		
	Bob's cost per share	Cost/share	$40		
	Total cost of shares sold	Cost	$40,000		
	Total price for 1,000 shares at $50 per share.	Selling Price	$50,000		
	Bob reports capital gain on sale of his stock.	Cap. Gain	$10,000	302	b
3b	**Assume Bob qualifies for "Dividend Treatment."**			301	
	Local pays $50,000 for half of Bob's stock.			301	a
	Bob reports dividend income.	Div. Income	$50,000		
	Actually, Bob cannot qualify for exchange treatment under the tax law.				
	Name five types of redemptions that get exchange treatment.	Sec. 302(b) and 303		302	b

Chapter 6. Redemptions and liquidations. Tab 2

	Sec.	Sub	

Corporation redeems stock - buys it back

Individuals prefer exchange treatment (Treat as Sale), over Dividend Treatment.

A bought 1,000 shares Big Corp. for $80,000.
A sells the stock to Big Corp. for $100,000.

	Dividend	Exchange	Sec.	Sub
Tax Impact on A	Sec. 301(c)	Sec. 302(a)		
Amount Received for Stock	$100,000	$100,000		
Less: Cost of Stock			302	a
Dividend income for shareholder			301	c
Capital gain or loss for shareholder				

Ann & Bob organized Local Corp. 5 years ago
with the stock investments shown below.

Local Corporation	Bk Value	FMV
Cash	$200,000	$200,000
Other Assets-		
Building, etc. (FMV $800,000)	300,000	800,000
Total assets	$500,000	$1,000,000
Common Stock (Ann)		
(1,000 Shares, $10 par)	10,000	100,000
Common Stock (Bob)		
(9,000 Shares, $10 par)	90,000	900,000
Retained Earnings	400,000	
Debt and Stockholder Equity	$500,000	$1,000,000

Case 1. Local redeems 500 shares from Bob at value of $50,000 — 302 c 2

	Shares Before	% Owned Before	Shares After	% Owned After
Ann	1,000			
Bob	9,000			
Total	10,000			

Is it a disproportionate distribution? Do they meet 80%, 50% test?

Case 2. Local redeems 500 shares from Ann at value of $50,000 — 302 c 2

	Shares Before	% Owned Before	Shares After	% Owned After
Ann	1,000			
Bob	9,000			
Total	10,000			

Is it a disproportionate distribution? Do they meet 80%, 50% test?

Chapter 6. Redemptions and liquidations. Tab 2			Sec.	Sub	
Corporation redeems stock - buys it back Individuals prefer exchange treatment (Treat as Sale), over Dividend Treatment.					
A bought 1,000 shares Big Corp. for $80,000. A sells the stock to Big Corp. for $100,000.					
	Dividend	Exchange			
Tax Impact on A	Sec. 301(c)	Sec. 302(a)			
Amount Received for Stock	$100,000	$100,000			
Less: Cost of Stock		($80,000)	302	a	
Dividend income for shareholder	$100,000		301	c	
Capital gain or loss for shareholder		$20,000			

Ann & Bob organized Local Corp. 5 years ago with the stock investments shown below.

Local Corporation	Bk Value	FMV
Cash	$200,000	$200,000
Other Assets-		
Building, etc. (FMV $800,000)	300,000	800,000
Total assets	$500,000	$1,000,000
Common Stock (Ann)		
(1,000 Shares, $10 par)	10,000	100,000
Common Stock (Bob)		
(9,000 Shares, $10 par)	90,000	900,000
Retained Earnings	400,000	
Debt and Stockholder Equity	$500,000	$1,000,000

Case 1. Local redeems 500 shares from Bob at value of $50,000 — 302 c 2

	Shares Before	% Owned Before	Shares After	% Owned After
Ann	1,000	10%	1,000	10.53%
Bob	9,000	90%	8,500	89.47%
Total	10,000	100%	9,500	100.00%

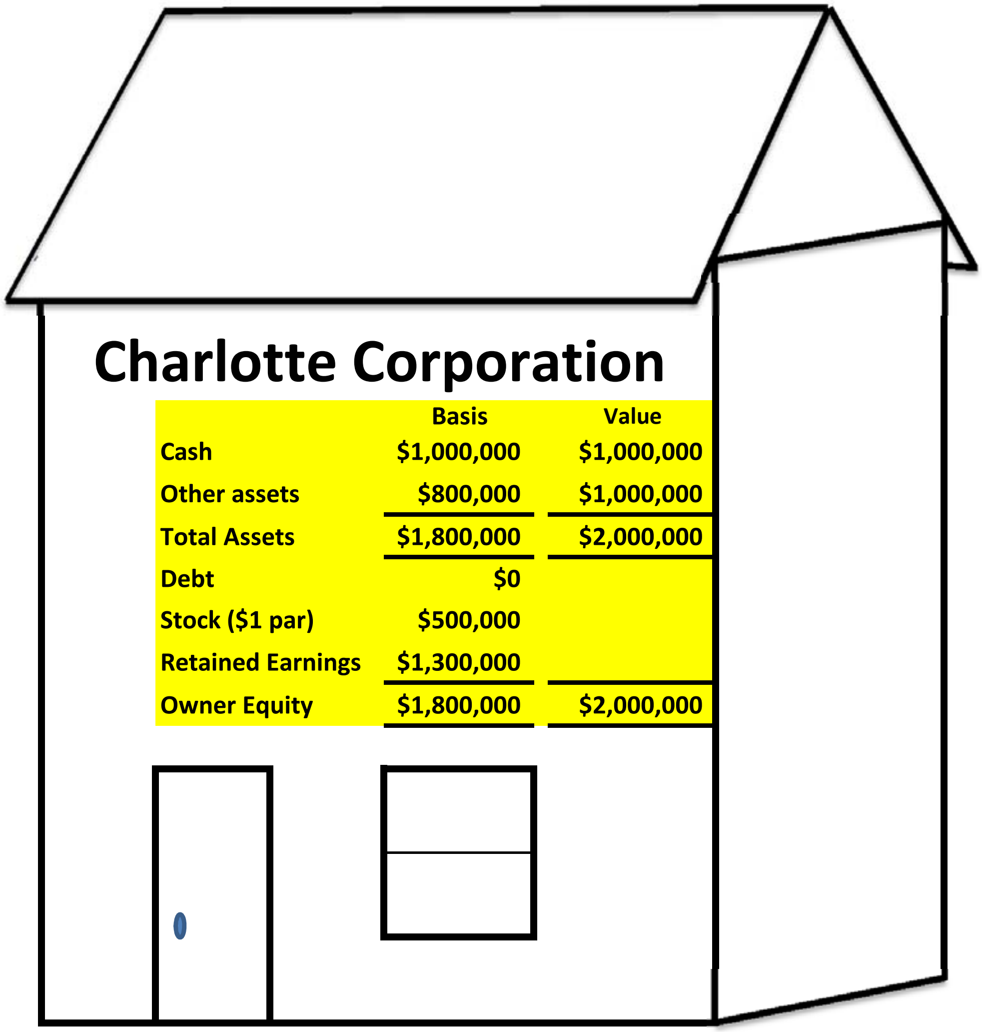
Is it a disproportionate distribution? Do they meet 80%, 50% test?

Case 2. Local redeems 500 shares from Ann at value of $50,000 — 302 c 2

	Shares Before	% Owned Before	Shares After	% Owned After
Ann	1,000	10%	500	5.26%
Bob	9,000	90%	9,000	94.74%
Total	10,000	100%	9,500	100.00%

Is it a disproportionate distribution? Do they meet 80%, 50% test?

Employee Buys Stock From Widow



Charlotte Corporation

	Basis	Value
Cash	$1,000,000	$1,000,000
Other assets	$800,000	$1,000,000
Total Assets	$1,800,000	$2,000,000
Debt	$0	
Stock ($1 par)	$500,000	
Retained Earnings	$1,300,000	
Owner Equity	$1,800,000	$2,000,000

Jan - Assistant Manager
Wants to buy the business
from Widow.
She has cash of $1,000,000.

Mr. Boss owned all of the stock with basis of $500,000.
Stock was worth $2,000,000 at his death yesterday.
Mr. Boss's widow (name is Beth) suggests that

1. **Jim can buy all of the stock in the company (that Beth just inherited) for $2,000,000.**
   Jim can pay $1,000,000 to Beth and give Beth a note payable for $1,000,000.
   Jim can sell half of the stock back to the company for $1,000,000 and pay off the note to Beth.

2. **Alternatively, Beth can have the corporation buy back half of the stock from Beth for $1,000,000.**
   Then Beth will sell the remaining outstanding stock to Jim for $1,000,000.

3. **A third possibility is for the widow (Beth) to sell half of her stock to Jim for $1,000,000.**
   Then, Beth can sell her remaining stock back to the corporation for $1,000,000.

Please evaluate all of these alternatives.
See next tab of this file for the solution

Charlotte Corporation

	Basis	Value
Cash	$1,000,000	$1,000,000
Other assets	$800,000	$1,000,000
Total Assets	$1,800,000	$2,000,000
Debt	$0	
Stock ($1,000 par, 500 shares)	$500,000	
Ret. Earnings	$1,300,000	
Owner Equity	$1,800,000	$2,000,000

Big Picture-Owner died

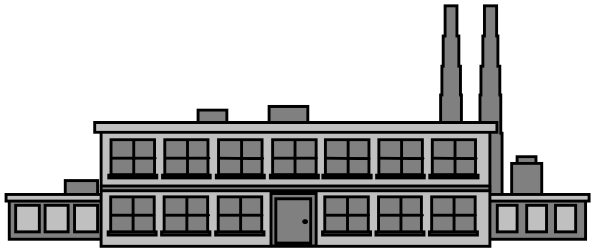
Owner died and his widow (Beth) inherited 100% of the stock.	
What is Beth's basis in 500 shares of the stock?	$2,000,000
Beth would LIKE TO sell 500 shares to key employee (Jim) for	$2,000,000
Jim has only $1,000,000 now to pay for the stock.	$1,000,000

Last tab for case: Michael Cerone
Or see file posted on web page
Note basic facts, and
then the Opinon,
especially the Conclusion.

		Sec.	Sub		
1. Sell stock to Jim					
Beth's Basis in 500 shares	$2,000,000	1014			
Beth sells 500 shares to Jim	$2,000,000				
Jim buys 500 shares.					
Jim pays: Cash	$1,000,000				
Jim gives: Note Payable	$1,000,000				
Then, Jim sells 250 shares of stock to corporation for	$1,000,000				
[Jim pays the notes payable to Beth.]					
Amount of income reported by Jim from redemption	$1,000,000	301			
Jim's income from redemption	Div. Income	302	a		
2 - Widow sells 250 shares to corp & 250 to Jim					
Beth sells 250 shares corp. for	$1,000,000				
Beth's income from redemption	$1,000,000	301			
Type of Beth's income	Div. Income	302	a		
Beth sells other 250 shares to Jim	$1,000,000				
Beth's basis in 250 shares sold to Jim	$2,000,000	1.302	-	2	c
Beth's gain (loss) on sale to Jim	($1,000,000)	1001			
3 - Widow sells 250 shares to Jim & 250 to Corp					
Beth sells 250 shares to Jim for	$1,000,000				
Beth's basis shares sold to Jim	$1,000,000				
Beth's gain from sale to Jim?	$0	1001			
Beth sells 250 shares to corp. for	$1,000,000				
Beth's basis in shares sold to corp	$1,000,000				
Beth's Income or gain from the sale?	$0	302	b	2	

Fred owned all 998 shares of Skyline Funeral Home. Fred died and his wife, Donna, inherited the stock.
Fred's estate had cash of $10,000, but owed estate taxes of $206,000.
Donna needed to sell the stock to get money for payment of estate tax.
David, an employee, obtained $600,000 bank loan and bought stock (998 shares) from Donna for $600,000.
Skyline redeemed 705 shares of his stock for $420,000, and assumed $420,000 of David's loan at bank.
IRS treated the stock redemption as a dividend, and assessed David with about $300,000 in taxes.
IRS won in Tax Court. (Top tax rate was 70%. Dividend income was ordinary income.)
David L.Schroeder, T.C. Memo 1975-334. Sec. 302(b)(1)

Stock Redemptions



Big Manufacturing Company

Bank

(Stock of company is worth $100,000)

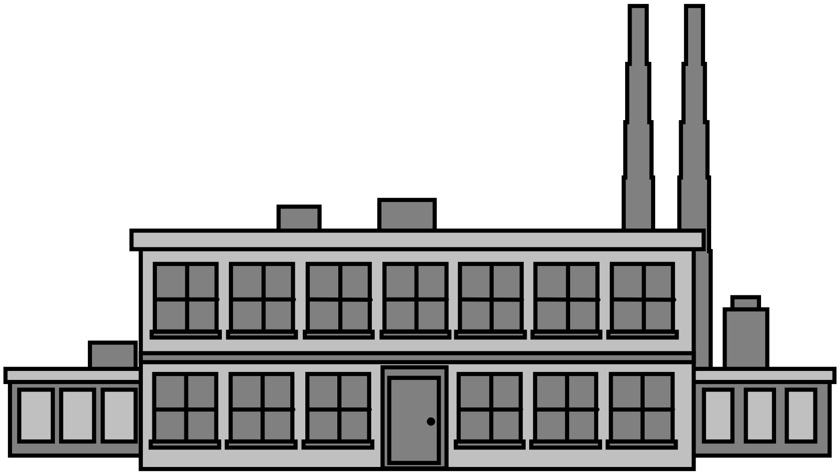
Stock ($10 par, 1,000 shares)	**$10,000**
Retained Earnings	**$90,000**
Total Equity (Value)	**$100,000**

Stockholder A	**Stockholder B**	**Investor C**
Owns 20% of Big Mfg. Co. (20 shares worth $20,000)	Owns 80% of Big Mfg. Co. (80 shares worth $80,000)	Has $60,000. and he wants to buy Big Mfg. Co.

Suppose Stockholder B has the corporation redeem 40 of his shares and then C buys all of the stock owned by Stockholder A and the remaining 40 shares owned by B? What are the tax results for Stockholder B?

Suppose Investor C borrows $40,000 from the bank, buys all stock owned by A and B, and then has the company redeem 40% of this stock for $40,000, so he can pay the bank?

Stock Redemption in Divorce



Big Manufacturing Company

	Book Value	Market Value
Assets	$5,000,000	$5,000,000
Liabilities	$3,000,000	$3,000,000
Common Stock		
($300 par, 2,000 shares)	$600,000	
Retained Earnings	$1,400,000	
Total Owner Equity	$2,000,000	$2,000,000
Total Debt and Owner Equity	$5,000,000	$5,000,000

Husband owns all of the stock, with a cost of $300 per share and a market value of $1,000 per share.
In the divorce, Wife wants $1,000,000.
Husband and wife are considering the following alternatives for sharing the wealth upon divorce.

1. **Husband has the corporation to redeem 1,000 of his shares for $1,000,000 and gives $1,000,000 to Wife.**
   His cost is $300,000, Redemption Price is $1,000,000. Gain $700,000?
2. **Husband gives 1,000 shares of stock to wife and she has the corporation redeem her stock for $1,000,000.**

Does the choice of action make a difference?

Michael N. Cerone. 87 T.C. No. 1

Father and son organized Stockade Cafe, Inc. and transferred thereto the assets of the business (including real estate and liquor license). They each purchased 50 shares of the corporation's common stock for $5,000. These shares were the only outstanding shares of stock in the corporation. Father and son also became the directors and the president and secretary/treasurer, respectively, of the corporation.

Father and son were both actively involved in managing the business. Father ran the cash register and supervised the waitresses in the restaurant. He had authority to sign the corporation's checks. For awhile, Father also ordered supplies for the business, but his son soon assumed that responsibility. Son ran the restaurant's kitchen and the bar. He also kept the corporation's books. Father and son shared responsibility for major management decisions and for hiring and firing personnel. The business steadily grew, and they expanded the facilities.

Father and son disagreed about the management and operation of the business. Father refused to follow operating rules for employees that son had established. Father frequently reinstated employees that son or another manager had dismissed or reprimanded. Father's failure to follow the rules in such circumstances increased the growing hostility between him and his son.

Father held big gambling games in a relatively large apartment located on the second floor of the building that housed the restaurant and the bar. Twice, the Omaha vice squad raided the building in search of betting slips or other evidence of Father's gambling activities. During one such raid, members of the vice squad ransacked the upstairs apartment. As they left the premises, the frustrated vice squad members walked through the restaurant and the bar and pulled out the telephones. A representative of the Nebraska Liquor Control Commission visited son and said to him, "Mick, you're going to have to get your father out of here or you ain't going to have no liquor license." Without a liquor license, both the restaurant and the bar business would have been ruined. After this, Father and son "could not get along at all." Son was deeply concerned about losing the liquor license.

Father and the corporation agreed that the corporation would redeem father's 50 shares of stock therein for $125,000 ($25,000 down; the balance of $100,000 was payable over seven years in equal, semiannual installments with interest at an annual rate of 6-1/2 percent.)

After the redemption, father's responsibilities primarily involved handling the cash register in the restaurant. Son had continuing back problems, sometimes suffered severe migraine headaches, and also had high blood pressure. Nonetheless, at no time after the redemption did father exercise any managerial authority in the restaurant or in the bar. Father had no authority to hire and fire personnel nor did his son consult with him regarding any management decisions. When son was absent, Mother usually took over his responsibilities.

[Years later, son sold business for over $1,000,000.]

Father reported as long-term capital gain, under the installment method, a portion of the total payments designated as principal that father received from the corporation during such year.

Opinion

The issue is whether the distributions are dividends under Sec. 301(a) taxable as ordinary income or payments in exchange for stock under Sec. 302(a) taxable as capital gain. Family attribution rules of Sec. 318 play an important role in this determination.

To have distributions treated as payments in exchange for stock under Sec. 302(a), father must bring himself within either Sec. 302(b)(1) or Sec. 302(b)(3). Sec. 302(b)(1) provides that "[s]ubsection (a) shall apply if the redemption is not essentially equivalent to a dividend." Sec. 302(b)(3) provides that "[s]ubsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder." These determinations involve the family attribution rules. According to Sec. 302(c)(1), "[e]xcept as provided in paragraph (2) of this subsection, Sec. 318(a) shall apply in determining the ownership of stock for purposes of this section." Under Sec. 318(a), certain individuals and entities are treated as owning stock actually owned by certain related individuals and entities. Specifically, under Sec. 318(a)(1)(A)

Conclusion

The corporation's redemption of father's stock failed to satisfy the requirements of either Sec. 302(b)(1) or Sec. 302(b)(3). Thus, the redemption must be treated as a distribution of property to which Sec. 301 applies. See sec. 302(d). Under Sec. 301 and 316, a distribution of property is treated as ordinary income to the extent it is made out of the corporation's earnings and profits. Secs. 301(a), 301(c)(1), and 316(a). Father do not suggest that the corporation's payments to petitioner were not made out of its E&P. Consequently, all such payments are ordinary income to the individual petitioners, and corporation is not entitled to deduct any of such payments as interest.

Deals Between Closely Held Corporations and Their Owners Require Special Care

The president and vice-president bought land from their closely-held corporation at a price of $200,000, which was based on a current appraisal of the land. The IRS disagreed with the value used by the taxpayers, and assessed additional personal income tax of over $2,000,000, along with penalties of about $605,000, and interest as well. The taxpayers beat the IRS in Tax Court. Owners and managers of closely-held corporations can learn some lessons from this recent case.

Background

Herbert Carver was president and Gerald Drucker was Vice-President of the Atlantic Corporation. Mr. Carver and Mr. Drucker were not stockholders, but they were treated as "constructive owners," because their wives were stockholders of the corporation. A developer contacted Mr. Carver and Mr. Drucker, and told them he wanted to locate a Stop & Shop store on land owned by the Atlantic Corporation. They decided to buy the land from the corporation, build a building and lease it to the developer.

CPA's Concerns

A stockholder who buys property from his or her corporation is treated as receiving a "constructive dividend" if the price that is paid to the corporation is less than the fair market value of the property. In other words, the stockholder reports taxable income if the property is bought at a discount.

Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Normally, when there is a sale of property, the selling price is its fair market value because independent parties have agreed upon the price. However, when a buyer purchases property from his own corporation, the price is not necessarily considered to be equal to market value.

Their CPA advised them to have the land appraised, and to use that appraisal as a basis for the price to be paid to the corporation. **The appraisal indicated that the land had a fair market value of $190,000. To make certain they were not buying at a discount, they set the purchase price at $200,000.** The purchase was completed, and they entered into an agreement to build a building and lease it for use as a Stop & Shop store for 25 years.

IRS Audit and Tax Assessment

The IRS audited the individual income tax returns of the Druckers and the Carvers. **The IRS decided that the land was worth a little over $4.2 million**. Using the IRS reasoning, Mr. Carver and Mr. Drucker had paid $200,000 for land worth over $4.2 million, resulting in a discount of about $4 million. Accordingly, they needed to report additional income of about $4 million on their personal tax returns.

Using the revised values, the IRS assessed additional personal income tax of a little over $2 million, and penalties of about $605,000. This became another in a long line of cases involving disputes over a transfer of property and the value of that property.

What do you think?

Homework for Chapter 7-Redemptions

Stock Redemptions. Dividend Treatment or Exchange Treatment?

1. [§301, §302, §1001, §1(h), §11, §243] R Corporation has substantial earnings and profits.
R Corporation redeemed 50 of Ted's shares (basis of $100 per share to Ted) for $60,000.
What was the effect of the redemption on Ted?

- **a.** $60,000 capital gain if it is treated as a dividend
- **b.** $60,000 dividend income if it is treated as a dividend
- **c.** $55,000 capital gain if it is treated as a dividend
- **d.** $55,000 dividend income if it is treated as a dividend

2. [§301, §302, §1001, §1(h), §11, §243] **Big Corporation** is owned by Jan.
Jan's stock has a basis of $250,000 and a FMV of $1,000,000. **Big C Corporation** has E&P of $300,000.
Jan will receive a distribution of $100,000 from **Big Corp.** in redemption 10% of her **Big Corp.** stock.
Jan will continue in her role as owner and CEO. What will be the tax effect of this redemption on Jan?

- **a.** $75,000 capital gain **b.** $75,000 dividend
- **c.** $100,000 dividend **d.** $100,000 capital gain

3. [§301, §302, §1001, §1(h)] **Beaver Corp.** is owned by two unrelated individuals, Ward and June.
Beaver Corporation has earnings and profits of $300,000.
Ward is not active in the business. He will retire from the business completely and move to Oregon.
Accordingly, Beaver Corporation will redeem all the stock owned by Ward.
In return, Ward will receive a distribution of $450,000. Ward's adjusted basis in the stock is $250,000.
What will be the tax effect for Ward?

- **a.** $150,000 capital gain **b.** $300,000 dividend
- **c.** $400,000 dividend **d.** $200,000 capital gain

4. [§301, §302, §1001] A corporation is **owned 90% by Jones** and **10% by Smith**.
Jones owns 90 shares with a cost of $100 per share.
Smith owns 10 shares with a cost of $100 per share.
The company redeems 50 shares from Jones at a redemption price of $300 per share.
No stock is redeemed from Smith.
This is not a redemption to pay death taxes, and it is not a partial liquidation. What is tax impact on Jones?

- **a.** Dividend income of $15,000 **c.** Dividend income of $10,000
- **b.** Capital gain of $15,000 **d.** Capital gain of $10,000 **e.** Other

5. [§301, §302, §1001] A corporation is **owned 70% by Jones** and **30% by Smith**.
Jones owns 70 shares with a cost of $100 per share.
Smith owns 30 shares with a cost of $100 per share.
The company redeems 50 shares from Jones at a redemption price of $300 per share.
No stock is redeemed from Smith.
This is not a redemption to pay death taxes, and it is not a partial liquidation.
What is the tax impact on Jones?

- **a.** Dividend income of $15,000 **c.** Dividend income of $10,000
- **b.** Capital gain of $15,000 **d.** Capital gain of $10,000 **e.** Other

6. [§301, §303, §1001] Mr. Rich owned 50% (1,000 shares) of the Rich Corporation when he died.
The 1,000 shares of Rich stock had a basis to him of $100,000, and had a fair market value of $2,000,000.
The corporation has earnings and profits of $700,000.
His estate included other assets with a value of $3,000,000. There was no debt.
The federal estate tax was $500,000. (Ignore state death taxes.) Which of the following is true?

- **a.** If the corporation redeems stock worth $500,000, the estate will get exchange treatment on the stock and there will be no taxable gain for the estate on the redemption.
- **b.** The estate can have the corporation redeem all 1,000 shares, and the estate will get exchange treatment on all of the stock that is redeemed.