

## 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

B

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	
<b>Total book value of assets</b>		<b>\$5,000,000</b>
Debt	\$0	
Common Stock (Owner's Investment)	\$500,000	
Retained Earnings (Also E & P)	\$4,500,000	
<b>Total Book Value of Debt and Equity</b>		<b>\$5,000,000</b>
<b>Total Value of All Corporate Assets</b>		<b>\$8,000,000</b>

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

C

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	
<b>Total book value of assets</b>		<b>\$2,500,000</b>
Debt	\$0	
Common Stock (Owner's Investment)	\$1,000,000	
Retained Earnings ( Also E & P)	\$500,000	
<b>Total Book Value of Debt and Equity</b>		<b>\$1,500,000</b>
<b>Total Value of All Corporate Assets</b>		<b>\$7,000,000</b>

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

B

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

C



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

D

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

C

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]

B

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?

	<b>Dividend Income</b>	<b>Capital Gain</b>
a.	\$20,000	\$10,000
b.	\$21,000	\$2,000
c.	\$22,000	\$1,000
d.	\$22,000	\$0

C

**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?

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

**C**

**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

**D**

**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)

**D**

**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?

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

**B**

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. This is not a liquidation or redemption. 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.

**B**

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     |

**D**

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     |

**C**

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

**D**

## 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

**C**

## 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

**C**

**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

**B**

**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

**B**