PROBLEM #I – Dividends, Actual and Constructive Redemptions, and Earnings and Profits

If a problem states that a corporation has an after-tax profit of some amount, unless the facts indicate otherwise, you will assume that the corporation has current earnings and profits of the same amount.

I-1 In Year One, X Corporation had gross income of $60,000 from an actively conducted business, and X received dividends aggregating $40,000 from domestic corporations. X did not own 20% or more (in value or in voting power) of the stock of any corporation. X had no other income in that year. X's total gross income for that year therefore was $100,000. What is the amount of X's dividend-received deduction and taxable income in the following alternative circumstances?

(a) Apart from the dividend-received deduction, in Year One, X had deductions aggregating $80,000. None of these deductions is attributable to a carryback or a carryforward or an interest expense.

(b) Apart from the dividend-received deduction, in Year One, X had deductions aggregating $80,100. None of these deductions is attributable to a carryback or a carryforward or an interest expense.

I-2 Corporation X has three equal shareholders, individual A, Corporation Y, and Corporation Z. X owns a building in which X has a basis of $3,000. X had depreciated the building on the straight-line method, and X had used the building in its business for more than 8 years. At the time in question, the fair market value of the building is $10,000. X also owns Whiteacre having a basis of $15,000 and a fair market value of $10,000. On the same date, X distributes $10,000 cash to A, the building to Y, and Whiteacre to Z. For purposes of § 301, what is the amount distributed to each shareholder? If the building had been encumbered by a $5,000 mortgage and if Y had received the building from X subject to that mortgage, what was the amount distributed to Y?

I-3 Corporation X has 150 shares of common stock outstanding – 50 of which are owned by A, an individual; 50 of which are owned by Y Corporation; and 50 of which are owned by Z Corporation. X offers to distribute to each of its three shareholders one of the following to be selected by each shareholder: (a) $10,000 in cash; (b) 20 shares of X's common stock having a value of $10,000; or (c) X's bond in the face amount of $12,000, which has a value of $10,000, bearing a modest rate of interest and maturing in 12 years. A and Y both choose the corporate bond, and X distributes a $12,000 bond to A and another to Y. As noted above, the fair market value of each bond is $10,000. In answering the questions herein, you will ignore issues concerning income or deductions that may arise as a consequence of original issue discount on X's bonds. Z chooses to receive the 20 shares of X's common stock; and as we shall later see, the distribution of the stock to Z will be included in Z's gross income under § 305(b)(1). X does not recognize any income from making these distributions. What amount is deemed to have been distributed to each of the three shareholders and what basis does each have in the distributed property? In this connection, see Treas. Reg. §§ 1.301-1(d)(1), (h); 1.305-2(b), Ex. (1)(iii).

I-4 As of January 1 of Year One, Y Corporation, which reports its income on a calendar year basis, had no accumulated *e and p*. On December 12 of Year One, Y sold Whiteacre to M, an unrelated individual, for $500,000, and Y had an adjusted basis of $200,000 in Whiteacre. Y's gain on this sale consituted ordinary income. In payment for Whiteacre, M paid Y $100,000 cash and gave Y his personal note for $400,000, which is payable in equal annual installments over a 10-year period beginning in Year Two and bears an adequate rate of interest. Y reported its gain from the sale of Whiteacre on the installment method, and accordingly reported only $60,000 of gain from that sale on its tax return for Year One. Apart from that sale, Y had other income of $20,000 in Year One and had *e and p* for that year of $20,000. To answer the question below, you will have to determine the effect that the sale had on Y's current *e and p* for Year One. In answering this question, you will assume that Y incurred no tax liability in Year One.

Y had two equal shareholders—individual B and Corporation Z. At the beginning of Year One, both shareholders had held their Y stock for more than two years.

(a) In Year One, Y distributed $100,000 cash to B and made no other distributions. This distribution to B was a § 301 distribution. What amount of that distribution to B is a dividend? As previously noted, the distribution will constitute a dividend to B to the extent that it does not exceed Y's *e and p*.

(b) In Year Two, Y collected $40,000 principal (plus interest) from M on M's installment note; and pursuant to the installment method, Y reported on its Year Two tax return $24,000 of gain from its collection of the $40,000 of principal. Apart from the $40,000 of principal that Y collected from M (and the $24,000 of income that Y recognized thereby), Y's other income and deductions (including the interest that Y received from M) for Year Two resulted in a net loss of $32,000 for purposes of computing taxable income. After taking into account the $24,000 gain that Y recognized on the installment sale and after making statutorily mandated adjustments, Y reported a net operating loss of $3,000 for Year Two. Y had no tax liability for that year. Although Y's other income and deductions netted a loss of $32,000 for purposes of computing taxable income, because of certain adjustments required for computing *e and p*, those items resulted in a deficit *e and p* of only $20,000. Thus, if the $24,000 installment gain were included in *e and p*, Y would have current *e and p* of $4,000 in Year Two. In Year Two, Y distributed $100,000 cash to Z and made no other distributions. The distribution to Z was a § 301 distribution. Z had taxable income of more than $200,000 in Year One and also in Year Two. What amount of that distribution was a dividend to Z? See § 301(e). Note that Y's accumulated *e and p* from Year One will be reduced by the $100,000 it distributed to B in that year. See § 312(a)(1).

(c) Assume that the order of distributions described above were reversed so that Y distributed $100,000 cash to Z in Year One and distributed $100,000 cash to B in Year Two. In that event, what amount of the distributions to Z and B respectively were dividends?

I-5 As of January 1, Year One, X Corporation, which reports its income on a calendar year basis, had no accumulated *e and p*. On November 4, Year One, X made a contribution of 100 shares of Win All, Inc., common stock to a qualified charity. X had a basis of $7,000 in the 100 shares of Win All stock, and the fair market value of those shares was $30,000. Without taking that contribution into account, X had taxable income of $40,000, and current *e and p* of a like amount. Because of the statutory limitation on the amount that a corporation can deduct for its charitable contributions (§ 170(b)(2)), X was allowed a deduction of only $4,000 for its contribution (albeit a carryover of the excess *may* be deducted in a subsequent year). Thus, after taking the charitable contribution into account, X had taxable income of $36,000. On November 18, Year One, X distributed $50,000 cash to its sole shareholder, A. Under § 316(a)(2), the amount distributed to A will constitute a dividend to the extent that X had current *e and p* for Year One. What amount of the cash distribution to A constituted a dividend? Compare Kaplan v. Commissioner, 43 T.C. 580, 599 (1965), nonacq., 1978-1 Cum. Bull. 2, with Rev. Rul. 78-123, 1978-1 Cum. Bull. 87.

I-6 On January 1, Corporation X had no accumulated *e and p*. For that year, X had current *e and p* of $5,000. On July 5, X distributed $15,000 cash to shareholder A, an individual. A had a basis of $3,000 in his stock of X. X made no other distributions in that year. X was not in existence in the year 1913. What was the income tax consequence to A?

I-7 The stock of *W* Corporation is owned equally by Jones, an individual, and Ownership, Inc., a corporation. By the close of year One, both shareholders had held their *W* stock for more than two years. Jones has a basis of $5,000 in his stock and Ownership has a basis of $12,000 in its stock. At the close of Year One, *W* had an accumulated *e and p* deficit of $40,000. In Year Two, *W* earned an after-tax profit of $30,000. *W* distributed $10,000 cash to Jones on February 6, Year Two, and distributed $10,000 cash to Ownership on March 4, Year Two.

(a) What amount of income did Jones recognize from the $10,000 distributed to him? How is that income to be characterized (ordinary income or capital gain)?

(b) What amount of income did Ownership recognize from the $10,000 distribution made to it? How is that income to be characterized?

(c) What is the accumulated earnings and profits of *W* as of January 1, Year Three?

I-8 Reed Corporation has two classes of common stock outstanding, Class A and Class B. The two classes of stock are of equal value. Jones owns 100% of the Class A stock, and Smith owns 100% of the Class B stock, and both shareholders have held their stocks for more than 8 years. On July 1, Year One, Reed distributed $20,000 cash to Jones on account of his Class A stock, and on December 31, Year One, Reed distributed $20,000 cash to Smith on account of his Class B stock.

(a) As of January 1, Year One, Reed had an accumulated *e and p* deficit of $20,000. Without regard to the distributions that Reed made to its shareholders, Reed earned $30,000 in that year, net of taxes. What is the dividend income of Jones and Smith? See Treas. Reg. § 1.316-1(e), Ex. (1), 2(b), 2(c), Ex. If on July 1, Year One, instead of having made a cash distribution to Jones, Reed had distributed to Jones unimproved land (Whiteacre) in which the corporation had a basis of $5,000 and which had a value of $20,000, and if the corporation had then distributed $20,000 cash to Smith on December 31, Year One, Jones and Smith would have what amount of dividend income?

(b) As of January 1, Year One, Reed had accumulated *e and p* of $30,000. In that year, Reed suffered a net loss of $10,000, all of which constituted a reduction in its *e and p*. What is the dividend income of Jones and Smith? See Treas. Reg. § 1.316-2(b).

(c) As of January 1, Year One, Reed had accumulated *e and p* of $15,000. In that year, Reed earned $10,000 net of taxes. What is the dividend income of Jones and Smith? See Treas. Reg. § 1.316-2(c), Ex.

(d) In questions (a), (b) and (c) above, what was the accumulated *e and p* of the Reed Corporation as of January 1, Year Two?

I-9 (a) Beane, an individual, owns 50% of the stock of Bilt Rite, Inc.; and Ownership, Inc. owns the remaining 50%. In March, Year One, Bilt Rite purchased two machines for $12,000 each. The class life of the machines under ADR (Asset Depreciation Range) was 9 years, and so the machines were 5-year class property under § 168 (ACRS). Bilt Rite elected to depreciate the machines on the straight line method over a 5-year period as permitted by § 168(b)(3). Bilt Rite did not expense any part of the cost of the machines under § 179. Bilt Rite took a deduction for straight line depreciation of each machine in the amount of $1,200 in Year One and $2,400 in Year Two. As of January 1, Year Three, Bilt Rite had accumulated *e and p* of $47,000. Bilt Rite earned an after-tax profit of $25,000 in Year Three. On January 2, Year Three, Bilt Rite distributed one machine to Beane and one machine to Ownership. Bilt Rite properly took a depreciation deduction of $1,200 for each machine in its tax return for Year Three. Each machine had a fair market value of $11,300 at the date of distribution. Bilt Rite made no other distributions in Year Three.

(1) What is the amount of dividend received by the shareholders?
(2) What bases do the shareholders have in the machines distributed to them?
(3) What effect do the distributions have on the *e and p* of Bilt Rite?

(b) The same facts as in (a) except that instead of depreciating the machines on the straight line method, Bilt Rite elected to depreciate them on the double declining balance method as provided by § 168(b)(1). Accordingly, Bilt Rite took depreciation deductions for each machine of: $2,400 in Year One, $3,840 in Year Two, and $1,152 in Year Three. The total depreciation taken for each machine for the three-year period is therefore $7,392. With that change of facts, answer questions (1)–(3) above.

I-10 Jones is the sole shareholder of Bona Fide Corporation. In Year One, Bona Fide owned Blackacre (unimproved land) having a basis of $10,000. In that year, Bona Fide borrowed $30,000 from the Friendly National Bank as a nonrecourse loan and secured the loan by a mortgage on Blackacre. In Year Eight, Bona Fide distributed Blackacre to Jones subject to the $30,000 nonrecourse mortgage. The fair market value of Blackacre at the date of distribution was $40,000; and at that date, Bona Fide had accumulated *e and p* of $50,000.

(a) Did Bona Fide recognize any gain or loss from the distribution?
(b) What amount of income did Jones recognize from the distribution?
(c) What basis does Jones have in Blackacre?
(d) What effect did the distribution have on Bona Fide's *e and p*?

I-11 Roe, Inc., has two shareholders, Bing and Taylor. Roe owned Blackacre with a basis of $20,000 and a value of $15,000. On December 28, Year One, Roe distributed Blackacre to Bing, and on January 2, Year Two, Roe distributed $15,000 cash to Taylor. Roe had no *e and p* on January 1, Year One, and it earned $30,000 after taxes in Year One. What is the tax consequence of the Year Two distribution of $15,000 cash to Taylor assuming no corporate net earnings or loss in that year?

I-12 X Corporation had 100 shares of common stock outstanding all of which were owned by individual A. X also had 1,000 shares of preferred stock outstanding; 800 shares were owned by individual B and 200 shares were owned by A. X's charter provides that an annual dividend of $10 is to be paid on each share of its preferred stock and that no dividend can be paid on its common stock unless the required dividend payment for that year has been made to the holders of X's preferred stock. B had a basis of $80,000 in his 800 shares of preferred stock, and A had a basis of $20,000 in his 200 shares of preferred stock. A had a basis of $100,000 in his 100 shares of X's common stock.

As of January 1, Year One, X had no accumulated *e and p*. In Year One, X had net income after taxes of $18,000. In Year One, X declared and paid a cash "dividend" of $10 per share on its preferred stock. Consequently, B received a "dividend" of $8,000, and A received a "dividend" of $2,000, on their preferred stock holdings. In that same year, X declared and paid a cash "dividend" of $30,000 on its common stock ($300 per share). As used in this paragraph, the term "dividend"' refers to a § 301 corporate distribution that is treated as a dividend for corporate law purposes; these § 301 distributions are not necessarily "dividends" for tax law purposes. Despite the small earnings of X, you shall assume that local corporate law characterizes as dividends all $40,000 of the distributed cash.

What amount of income did A and B recognize from the cash distributions they received from X in Year One? Compare Rev. Rul. 69-440, 1969-2 Cum. Bull. 46 with Treas. Reg. § 1.316-2(b).

I-13 Hathaway, Inc., employs John Merritt, its sole shareholder, as president of the corporation at a salary of $50,000 per year. It is determined by a Tax Court decision that the salary paid to Merritt is excessive and that $30,000 is a reasonable salary for him. What are the tax consequences of that determination?

I-14 On January 1, Merriweather, Inc. had accumulated *e and p* of $50,000. Merriweather owned Blackacre (unimproved land) in which it had a basis of $30,000 and which had a fair market value on January 1 of $20,000. All of the stock of Merriweather is owned by John Jones, an individual. On January 1, Merriweather sold Blackacre to Jones for $10,000.

(i) Did Merriweather recognize a gain or loss on the sale?
(ii) Did Jones recognize any income because of the sale?
(iii) What effect did the sale have on Merriweather's *e and p*?
(iv) What basis does Jones have in Blackacre?
(v) Would it change your answers to any of the questions above if Merriweather had four equal and unrelated shareholders so that Jones owned 25% of Merriweather's outstanding stock?

I-15 Jones has a vested remainder interest in the ST trust, which interest is valued at an amount equal to 4% of the corpus of the trust. Hilltop, Inc., has 100 shares of stock outstanding. Jones owns 75 shares of Hilltop stock and the ST trust owns the remaining 25 shares.

(a) After applying § 318, how many shares of Hilltop is Jones deemed to own?
(b) After applying § 318, how many shares of Hilltop is the trust deemed to own?
(c) If instead of a vested remainder, Jones has a contingent remainder interest in the ST trust and the dollar value of his contingent remainder interest is equal to 4% of the corpus of the trust, what would be the answers to questions (a) and (b) above?

I-16 A and B are equal beneficiaries of an estate which owns 100 shares of stock of Y Corporation. B individually owns 40 shares of Y stock. A's wife, W, owns 10 shares of Y stock. After applying § 318, what amount of stock of Y is owned by the following persons: B, W, the estate?

I-17 D and E are equal partners in an investment partnership which owns 100 shares of stock of Z Corporation. Neither D nor his wife, W, own any stock of Z in their individual capacities; but S, who was W's son by a prior marriage, owns 40 shares of Z stock in his own name. W has a vested remainder in the PT trust created by her father, and the actuarial value of her remainder interest equals 20% of the corpus of the PT trust. After applying § 318, how many shares of Z stock are deemed owned by D, by S, and by the PT trust?

I-18 X Corporation has 100 shares of common stock outstanding. David owns 40 shares of X's stock. David's son-in-law, Ralph, owns 40 shares. The remaining 20 shares are owned by Mary, who is both the daughter of David and the wife of Ralph. Ralph's father, John, died recently and left his property to his children. John's estate, which currently is being administered by John's executors, owns 50 shares of common stock of Y Corporation. X itself owns 150 shares of stock of Y. After applying § 318, how many shares of stock of Y is John's estate deemed to own?

I-19 P died, and in his will he made a $20,000 pecuniary bequest to his sister, R, and left the residue of his property to his daughter, T. At the time of his death, P owned 100 shares of the common stock of X Corporation; and P's sister, R, owned the remaining 80 shares of outstanding common stock of X. X is willing to redeem 50 shares of its stock held by P's estate, but the distribution in redemption will be treated as a § 301 distribution if R's 80 shares of X stock are attributed to P's estate. The distribution in redemption will not be treated as a § 301 distribution if R's 80 shares of X stock are not attributed to the estate. P's executor proposes first to distribute to R her $20,000 bequest and then, some days subsequent thereto, to permit X to redeem the 50 shares of its stock from the estate. Will the executor's plan succeed in preventing the attribution of R's 80 shares to the estate? See Treas. Reg. § 1.318-3(a); Estate of Edwin C. Weiskopf v. Commissioner, 77 T.C. 135 (1981); Estate of Webber, Sr. v. United States, 404 F.2d 411 (6th Cir. 1968).

I-20 X Corporation had 400 shares of common voting stock outstanding; A owned 200 shares and B owned 200 shares. A and B are not related parties. A had a basis of $100 in each share of X stock. X Corporation had *e and p* of over $50,000. X redeemed 100 shares of A's stock for $20,000 cash and made no other distributions in that year. The following year A sold 5 shares of X stock to C for $1,000.

(a) What was the tax consequence to A of the redemption of 100 shares of X stock? What was the tax consequence of A's sale of 5 shares of X stock to C?

(b) Instead of having only 400 shares of common stock outstanding, X had 600 shares outstanding and A owned 300 shares (having a basis of $100 per share) and B owned the remaining 300 shares. X redeemed 100 of A's shares for $20,000 cash. What was the tax consequence to A of that redemption? What was the tax consequence of A's sale of 5 shares of stock to C in the following year?

(c) Would you change your answer to questions (a) and (b) if:
(i) A and B were half-brothers;
(ii) A were the adopted child of B;
(iii) A had lived with B since A's birth and had been treated as B's child but had never been legally adopted;
(iv) A and B were equal partners in a hardware business?

I-21 High View Corporation had 800 shares of common stock outstanding. High View had accumulated *e and p* of $95,000 and no current earnings in the year in question. Two hundred shares of High View's stock were owned by John Jones; 200 shares were owned by Paul Jones, the son of John Jones; 200 shares were owned by Robert Jones, the son of Paul Jones; and 200 shares were owned by Ownership, Inc. All of the outstanding stock of Ownership is owned by Robert Jones. Ownership had a basis of $40,000 in its 200 shares of High View's stock. Robert Jones had a basis of $50,000 in his 200 shares of High View's stock. High View redeemed the 200 shares of its stock owned by Ownership for $100,000. High View made no other redemptions or distributions in that year. What was the tax consequence to Ownership?

In the following year, Robert Jones sold his 200 shares of High View's stock to Harold Wellington, an unrelated party, for the price of $100,000. What was the tax consequence to Robert of that sale?

I-22 X Corporation had 100 shares of stock outstanding. H owned 50 shares; W-1 (H's first wife) owned 10 shares; and W-2 (H's second wife) owned 40 shares. H had been divorced from both W-1 and W-2. Upon H's death, his will provided a pecuniary bequest to his brother, B, and he left his residuary estate to S (a son of H and W-1) and D (a daughter of H and W-2). X redeemed from H's executor all 50 shares of X's stock held by H's estate, and that redemption did not qualify for § 303 treatment. The executor wishes to invoke § 302(c)(2)(C) and prevent the attribution of the stock held by W-1 and W-2 to their respective children since those shares will be reattributed to the estate. If both S and D join with the estate in making the election to waive the family attribution rules and agree to joint and several liability for deficiencies, the redemption of the estate's stock can qualify as a purchase by virtue of § 302(b)(3) provided that neither the estate, S nor D acquires a prohibited interest in X within the proscribed ten-year period. It is not necessary that B join in the election since no stock of X will be attributed to B by family attribution rules. However, if only D consented to join with the estate and S refused, the waiver would not be effective.

I-23 The same facts as above in **I-22** except that W-1 predeceased H and left her estate, including her ten shares of X stock, in trust for the benefit of her son, S, for his life. H's estate, S and D file a timely election under § 302(c)(2)(C). Will X's redemption from H's estate of 50 shares of X stock qualify as a purchase?

I-24 If, in **I-22**, after the redemption of the estate's stock, X had needed additional capital and had obtained it by issuing five new shares of stock which it sold to B, and if the sale to B took place prior to H's executor's having distributed the pecuniary bequest to B so that B was still a beneficiary of the estate, will B's acquisition of stock, which is attributed to the estate under § 318(a)(3), be treated as an acquisition by the estate itself which voids the previous election to waive family attribution rules? If, instead of B's having purchased the five new shares of X's stock, the five shares were purchased from X by B's wife, M, would that be treated as a prohibited acquisition by the estate?

I-25 As of January 1, Year One, X Corporation had accumulated earnings and profits of $90,000. X had no earnings or loss in that year, and so it had no current *e and p* for that year. X had 300 shares of $100 par common stock outstanding—which were owned equally by individuals A, B, and C. X had a capital stock account (for all 300 shares of its common stock) of $30,000. The net worth of X was $180,000. On March 4, Year One, X redeemed all of A's 100 shares of X stock for $60,000, and this redemption qualified as a complete termination of A's interest under § 302(b)(3). On September 5, Year One, X distributed $40,000 cash to B and $40,000 to C on account of their stock holdings. What amounts of the distributions made to B and C will be treated as dividends?

I-26 As of January 1, Year One, X Corporation had 100 shares of stock outstanding and had no positive or deficit accumulated *e and p*. Individuals A and B owned 30 shares each of X's stock and individual C owned the remaining 40 shares. A, B and C are unrelated. In Year One, X had current *e and p* of $100,000. On July 1, Year One, X redeemed C's 40 shares of stock. X distributed $84,000 to C in redemption of his stock. On December 6, Year One, X paid a dividend of $35,000 cash to A and a like amount to B. So, X's dividend distributions in Year One totaled $70,000. What is the accumulated *e and p* of X as of January 1, Year Two? See Rev. Rul. 74-338, 1974-2 Cum. Bull. 101.

I-27 At the beginning of Year One, A, an individual, owned all 100 shares of the outstanding stock of Corporation X and all 100 shares of the outstanding stock of Corporation Y. A had a basis of $1000 in each share of X and Y stock. The value of the X shares was $2,000 per share. X had accumulated *e and p* of $15,000, and apart from the transaction in question X earned current *e and p* of $8,000 in Year One. X made no distributions in that year. Y had no accumulated *e and p*, and, apart from the transaction in question, Y had a deficit of $20,000 for its current *e and p* in Year One. In March of Year One, A sold 10 shares of X stock to Y for $20,000 cash. This sale is covered by § 304(a)(1); it is treated as a transfer of 10 shares of X stock to Y in exchange for Y stock of an equal value followed by Y's redemption for $20,000 of the Y stock that A is deemed to have received in the exchange. The $20,000 redemption payment is treated as a § 301 distribution of $20,000 from Y to A. Under pre-TEFRA rules, the § 301 distribution would not be a dividend because Y had no *e and p*. Under current law, the $8,000 of X's current *e and p* and $12,000 of its accumulated *e and p* will be allocated to the $20,000 distribution that Y made to A. Consequently the $20,000 distributed to A will constitute a dividend to him. At the beginning of Year Two, X will have accumulated *e and p* of $3,000, and Y will have an accumulated *e and p* deficit.

I-28 The same facts as those given above in **I-27** except that the property distributed by Y to A was unimproved land (Blackacre) which had a value of $20,000. Y had a basis of $5,000 in Blackacre. What amount of dividend income did A have? Did X or Y recognize a gain? What was the effect of this transaction on the *e and p* of X and Y? What would be the tax consequence of this transaction if Y had no current or accumulated deficit *e and p* for Year One?

I-29 The same facts as those stated above in **I-27** except that A died in April of Year One and left his estate to his daughter, B. In November of Year One, X distributed $30,000 cash to B. What amount of dividend income did A have? What was the tax consequence to B of her receipt of $30,000 from X? What would be the tax consequence to B if X had zero accumulated *e and p* at the beginning of Year One.

I-30 The same facts as those stated above in **I-28** except that at the beginning of the year, X had no accumulated *e and p*. Did Y or X recognize a gain? What effect did the transaction have on the *e and p* of X and Y?

I-31 The same facts as those stated in **I-27** except that A died in January of Year One, and, in March, A's estate sold the 10 shares of X stock to Y in a transaction which qualified as a purchase under § 303. Does that transaction cause a reduction of the amount of X's *e and p*? Of Y's *e and p*?

I-32 X Corporation had 200 shares of common stock outstanding; and Y Corporation had 500 shares outstanding. Y had $150,000 accumulated *e and p*, and X had no accumulated *e and p* at the time of the transactions described below. Apart from what income X may have recognized as a consequence of the transactions described below, X had no other earnings in the year in which these events occurred. Neither X nor Y made any other distributions that year.

(a) George Johnson owned all of the outstanding stock of X (200 shares) and of Y (500 shares). George sold 100 shares of X stock to Y for their fair market value ($50,000) which was $40,000 more than his $10,000 basis in those shares. What were the tax consequences of that sale?

(b) Assume that George owned only 100 shares of the stock of X and 250 shares of the stock of Y, and that the remaining shares of X and Y were owned by persons who are not related to George. George sold his 100 shares of X stock to Y for $50,000. George had a basis of $10,000 in those shares. What were the tax consequences of that sale?

(c) Assume that George owned all 200 shares of the outstanding stock of X, and that X owned all 500 shares of the outstanding stock of Y. George sold 100 shares of X stock to Y for $50,000; and George had a basis of $10,000 in those shares. What were the tax consequences of that sale?

(d) Assume that George owned all 200 shares of outstanding stock of X, and that X owned 250 shares of stock of Y, and that the remaining 250 shares of stock were owned by B, an unrelated party. George sold 160 shares of X stock to Y for $80,000 cash, which was $60,000 more than his $20,000 basis in those shares. What were the tax consequences of that sale?

I-33 Richard Scott owned 70 of the 100 outstanding shares of stock of A Corporation; the remaining 30 shares of A's stock were owned by an unrelated party. Scott also owned all 100 outstanding shares of stock of B Corporation. A owned all 100 outstanding shares of stock of S Corporation, and A had a basis of $30,000 in those 100 shares of S stock. At the time in question, A had accumulated *e and p* of $20,000; B had accumulated *e and p* of $55,000; and S had accumulated *e and p* of $20,000. A sold its 100 shares of S stock to B for $42,000 (its fair market value). What were the income tax consequences to A? What basis did B acquire in the 100 shares of S stock that it purchased? What effect did the sale to B have on Scott's basis in his stock in A and in B? See Rev. Rul. 70-496 and Coyle v. United States, 415 F.2d 488, 493 (4th Cir. 1968).

I-34 X Corporation had 200 shares of common stock outstanding, and Y Corporation had 600 shares of common stock outstanding. At the time in question X had accumulated *e and p* of $15,000; and Y had accumulated *e and p* of $100,000. Neither X nor Y had any current *e and p* in the year in question. A owned all 200 shares of the outstanding stock of X, and A had a basis of $80,000 in those shares. A's daughter, D, owned all 600 shares of the outstanding stock of Y, and she had a basis of $150,000 in those shares. A sold to Y 100 shares of the X stock he owned (A had a basis of $40,000 in those shares), and Y paid A $62,000 cash for those shares. What were the tax consequences of that sale?

If A had sold Y all 200 shares of his stock of X, and Y had paid A $124,000 cash for those shares, what would be the tax consequences? See Rev. Rul. 71-563, 1971-2 Cum. Bull. 175. Would it matter that A was employed by X as its Treasurer and that A continued to serve as X's Treasurer after the sale to Y was completed? Instead, would it matter if A were employed by Y as its Treasurer and continued to serve in that capacity after the sale?

I-35 X Corporation had 100 shares of voting common stock outstanding of which A owned 40 shares, B owned 40 shares, and C owned 20 shares. X had no other shares of stock outstanding. A, B and C are unrelated individuals. X has accumulated *e and p* of more than $50,000. X distributed a stock dividend of 10 shares of its voting common stock, and those 10 shares were allocated 4 shares each to A and B and 2 shares to C. At the time of distribution, A was given the right to have 3 shares of the stock she received as a dividend redeemed by X for cash; B was given the right to have 2 shares of the stock that he received as a dividend redeemed for cash; and C was given the right to have 1 of the shares that she received as a stock dividend redeemed for cash. If redemption were elected by a shareholder, the selected shares would be redeemed at their fair market value of $2,000 per share. None of the shareholders elected to have any shares redeemed. X made no other distributions in the year in which the stock dividend was paid. What was the tax consequence to each of the shareholders for receiving the stock dividend? See Rev. Rul. 83-68.

I-36 X Corporation has 100 shares of voting common stock outstanding of which 50 shares are held by A and 50 shares are held by the estate of B, who died recently. The shares of stock that are held by the estate of B qualify for redemption under § 303. The parties wish to have some of the estate's stock redeemed under § 303, but they do not wish to affect the equal division of control. To accomplish a redemption without altering control, a plan has been proposed to have X pay a stock dividend of nonvoting common stock to A and to the estate of B. The corporation will promptly redeem the estate's nonvoting stock, and A will retain his nonvoting shares. How would you evaluate the tax consequences of this proposal? See Rev. Rul. 87-132, 1987-2 Cum. Bull. 82.

I-37 The total outstanding stock of Wren Corporation was 200 shares of common stock. Carl Jones owned 100 shares, and Bill Russell owned the remaining 100 shares. Jones had a basis of $10,000 in his 100 shares which he had acquired for that amount some years earlier. As of Year One, Wren had accumulated *e and p* of $5,000, and it had no current *e and p* in that year.

(a) In Year One, Wren declared a stock dividend of ¼ share of common stock for each outstanding share of its capital stock and, accordingly, distributed 25 shares each to Jones and to Russell. The fair market value of those 25 shares was $1,500. What were the tax consequences of this dividend to Jones and to Wren?

(b) Three months after receiving the stock dividend, Jones sold the newly acquired 25 shares to his brother, Ted, for $1,500. See, Treas. Reg. § 1.1012-1(c). Was any gain or loss recognized on this transaction? How would you characterize the gain or loss, if any? Note § 267.

(c) In lieu of a common stock dividend, in Year One, Wren issued to each shareholder "rights" for 30 days to purchase one share of common stock of Wren for each share of stock then held by the shareholder. The price at which stock could be purchased under these rights was $85 per share, and the fair market value of the stock at that time was $100 per share. The fair market value of the "rights" issued to the shareholders is determined to be equal to $15.00 for each share of stock subject to those rights. What were the tax effects to Jones and to Wren of the distribution of those rights? If ten days after acquiring them, Jones were to sell his rights to acquire 100 shares of stock to his brother, Ted, for $1,500, what amount of gain or loss would Jones recognize and how would it be characterized? We will later consider whether § 306 might apply to that sale.

(d) Assume the same facts as those stated in (c) except that after holding the rights for 10 days, the fair market value of the stock rose to $110 per share, and Fred Beane offered to purchase the rights held by Jones for $2500, or if Jones preferred to exercise the rights first, to purchase the 100 shares of newly acquired stock for $11,000. Should Jones sell the rights or exercise them and sell the stock? If the fair market value of the stock declined to $90 per share, should Jones sell the rights for $5, or exercise the rights and sell the stock?

(e) In lieu of a common stock dividend, in Year One, Wren offered Jones a choice of either a stock dividend of ¼ share of common stock for every share of common owned by such shareholder or a $25 cash dividend for each such share. Russell was not offered a choice, and the corporation distributed to Russell a dividend of 25 shares of common stock. Jones chose to receive the stock dividend of 25 shares of common stock. What was the tax effect to Jones, to Russell, and to Wren?

I-38 Rand Corporation owned all 100 shares of the outstanding stock of Pineview Corporation. Jones is the sole shareholder of Rand. Rand declared a dividend and distributed 25 shares of Pineview stock to Jones. What was the tax effect of the distribution?

I-39 Abel Corporation distributed 100 shares of its common stock, having a fair market value of $10,000, to its president, who is not a stockholder in Abel. What were the tax consequences to Abel and to the distributee?

I-40 Win All, Inc., has two classes of common stock outstanding. Jones owns all 100 shares of Class A stock and Smith owns all 100 shares of Class B stock. Class A and Class B stocks share equally in dividend and liquidation distributions. Win All had accumulated *e and p* in excess of $50,000.

(a) On February 2, Year Three, Win All paid a cash dividend of $100 per share on its Class A stock, and it paid a stock dividend of $100 par preferred stock on each share of its Class B stock. What were the tax consequences of those dividends?

(b) Each share of Class A common stock can be converted to a share of Class B common stock at the option of the stockholder. Every year, the conversion ratio is increased by .06 of a share. The Class A stock was issued on January 12, Year One. Thus, during Year One each share of A stock could be converted to one share of B stock; in Year Two each share of A could be converted to 1.06 shares of B; in Year Three each share of A could be converted to 1.12 shares of B, etc. No dividends were paid on the B stock in Years One or Two, but a cash dividend was paid in Year Three. What were the tax consequences to Jones in Year Two if he did not convert his A stock? Would it affect your answer if no dividends were paid on the Class B stock in any of the years in question?

I-41 Win All, Inc., had 100 shares of common stock outstanding of which Jones owned 60 shares and Smith owned 40 shares. Jones and Smith are unrelated. Ripley, Inc., had 300 shares of common stock outstanding of which Jones owned 150 shares and Smith owned 150 shares. Win All had accumulated *e and p* in excess of $70,000; and Ripley had accumulated *e and p* in excess of $100,000. On February 10, Win All paid its shareholders a dividend of one-tenth of a share of its common stock for each share of its stock held by the shareholder. Thus, Win All distributed six shares of its stock (having a value of $6,000) to Jones and distributed four shares of its stock (having a value of $4,000) to Smith. On the following day, Jones sold to Ripley the six shares of Win All's stock that he had just acquired, and Ripley paid Jones $6,000 for those shares. What was the tax consequence to Smith for receiving the four shares of stock distributed to him? What would be the tax consequence to Smith if he owned no shares of Ripley's stock and if his 150 shares of Ripley stock were instead owned by Allen, an unrelated party.

I-42 In Year Five, the 100 outstanding shares of common stock of Piedmont Corporation were owned equally by individuals A, B, C and D who had owned their respective shares since Year One. As of January 1 of Year Five, Piedmont had accumulated *e and p* of $1,000. In Year Five, Piedmont declared a dividend of one share of preferred nonvoting stock for each outstanding share of common stock. The fair market value of each preferred share was $20. A, B, C and D each had a basis of $40 per share in their common stock. The fair market value of the common stock immediately after the distribution was $40 per share. Piedmont had no current *e and p* in the year in which the dividend was made, and it made no other distributions to shareholders in that year.

(a) Was any gain recognized by A upon receiving his 25 shares of preferred stock?

(b) (i) A subsequently sold his 25 preferred shares to Y for $20 per share. What was the tax consequence to A of that sale?
(ii) What would be the tax consequence to A if Piedmont had redeemed A's 25 preferred shares at $20 per share?
(iii) Assume the same facts as those in (b)(i). A subsequently sold his 25 shares of Piedmont's common stock at $45 per share. What was the amount of A's gain?
(iv) Assume the same facts as those in (b)(ii). A subsequently sold his 25 shares of Piedmont's common stock at $45 per share. What was the amount of A's gain?

(c) B subsequently gave his 25 preferred shares to his brother X, and X sold them for $35 per share. What was the tax consequence to B and to X?

(d) C died and bequeathed all of his stock in Piedmont to his son, S. S sold the preferred shares to Z for $20 per share. What was the tax consequence to S?

(e) In a subsequent exchange of stock pursuant to a recapitalization that qualified for nonrecognition of gain or loss, D exchanged his 25 preferred shares for 25 shares of common stock, and then Piedmont redeemed 25 shares of D's common stock at $40 per share. D's basis in the 25 shares of common stock he acquired equals his basis in the 25 shares of preferred stock that he transferred. What was the tax consequence of that redemption to D?

(f) Instead of giving his preferred stock to X, B gave it to the American Red Cross. Are there any tax advantages to making that gift?

(g) B owned all 100 shares of outstanding common stock of Mickey Corporation and had owned those shares since Year Three. In Year Six, B transferred his 25 shares of preferred stock in Piedmont to Mickey in exchange for 10 shares of Mickey's common stock. This exchange qualified for nonrecognition of gain or loss under § 351 (transfers to a controlled corporation). B's basis in the 10 shares of Mickey common stock that he acquired in the exchange equals the basis that B had in the 25 shares of Piedmont's preferred stock that he transferred to Mickey. § 358(a)(1). Mickey acquired a basis in the 25 shares of Piedmont's stock that it received equal to the basis that B had in those shares.

(i) Seven months later, B sold the 10 shares of common stock he had received from Mickey to Z for $75 per share. What is the tax consequence of that sale? See, Rev. Rul. 77-108, 1977-1 Cum. Bull. 86. What would be the tax consequence of B's sale of 10 shares of Mickey to Z if B did not designate which 10 shares of Mickey stock held by him he was selling (i.e., before the sale, B had a single stock certificate representing 110 shares of Mickey stock; and when he sold 10 shares, he did not designate which 10 of the 110 shares was the subject of the sale)?

(ii) Piedmont subsequently redeemed the 25 shares of its preferred stock held by Mickey for $30 per share. What is the tax consequence of that redemption?

(h) D died two months before the preferred stock dividend was declared by Piedmont, and consequently, the 25 shares of preferred stock were distributed to D’s executor. The Piedmont common stock owned by D at his death qualified for the tax treatment granted by § 303. Eight months after the stock dividend was distributed, Piedmont redeemed the 25 shares of preferred stock held by D’s estate at $20 per share. What was the tax consequence of that redemption?