CHAPTER 18

CORPORATIONS: DISTRIBUTIONS NOT IN COMPLETE LIQUIDATION

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Taxation of corporate distributions	Unchanged	1
2	Definition of *earnings and profits*	Unchanged	2
3	Comparison of accounting methods under E & P and income tax	Unchanged	3
4	Effect of distribution, taxable dividend or return of capital, in selected situations	Unchanged	4
5	Effect on E & P of gains and losses from property transactions	Unchanged	5
6	Planning corporate distributions—beginning or end of tax year	Unchanged	6
7	Purpose of property dividend versus cash dividend	Unchanged	7
8	Property distribution: choice of property	Modified	8
9	Issue ID	Unchanged	9
10	Impact of liabilities on tax treatment of property distributions	Unchanged	10
11	Issue ID	Modified	11
12	Issue ID	Unchanged	12
13	Selected factors in determining reasonableness of compensation	Unchanged	13
14	Importance of double taxation to corporate and individual shareholders	Modified	14
15	Unreasonable compensation from corporation	Unchanged	15
16	Issue ID	Unchanged	16
17	Sale or exchange versus dividend treatment on redemption	Modified	17
18	Basis of property received in a qualifying stock redemption	Unchanged	18

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
19	Effect of state law on tax treatment of stock redemption	New	
20	Family members included as "related parties" in attribution rules	Unchanged	19
21	Attribution from and to an entity	New	
22	Basis of stock in a nonqualified stock redemption	Unchanged	21
23	Requirements for a not essentially equivalent redemption	New	
24	Issue ID	Unchanged	22
25	Redemption to pay death taxes; attribution rules	Unchanged	23
26	Redemption to pay death taxes; 35% test	Modified	24
27	Issue ID	Unchanged	25
28	Gain/loss recognition to corporation on redemption distribution	Modified	26
29	Amount of dividend income	Modified	27
30	Amount of taxable income; balance in E & P	Unchanged	28
31	Deficit in E & P followed by sale on installment method; taxation of dividend distribution	Unchanged	29
32	Cash distributions; determination of taxable amount	New	
33	Cash distributions; determination of taxable amount; gain on sale of stock	Unchanged	31
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35	Effect of specified transactions on taxable income; on E & P	Unchanged	33
36	Effect of specified transactions on taxable income; on E & P	Unchanged	34
37	Tax treatment to corporate shareholder and to distributing corporation of property subject to a liability	Modified	35
38	Taxation of dividend when E & P has positive balance but corporation has current loss	Unchanged	36
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43	Dividend distribution; effect on E & P	Unchanged	41
44	Dividend distribution; effect on E & P	Unchanged	42
45	Stock dividend; basis allocation; gain on sale	Unchanged	43
46	Stock rights; basis allocation; gain on sale	Unchanged	44
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Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
50	Complete termination redemption [§ 302(b)(3)]; family attribution waiver	Unchanged	48
51	Sale of stock versus complete termination redemption; effect on retiring shareholder, remaining shareholder, and corporation	Unchanged	49
52	Redemption of stock to pay death taxes; estate sale of property received	Unchanged	50
53	Complete termination redemption followed by distributions to remaining shareholders; consequences to shareholders and effect on E & P	New	
54	Effect of redemption on corporation; E & P adjustment and treatment of redemption expenses	Unchanged	52

CHECK FIGURES

29. Ordinary dividend income $80,000 each, Laura reduces basis in stock to $10,000, Kelly reduces stock basis to zero and capital gain $7,000.
30.a. $370,000.
30.b. $770,000.
31. $300,000 taxable dividend.
32.a. $70,000; $60,000.
32.b. $140,000; $70,000.
32.c. $150,000; $0.
32.d. $80,000; $50,000.
32.e. $100,000; $30,000.
33.a. $120,000; $10,000.
33.b. $100,000; $0.
33.c. $70,000; $0.
33.d. $50,000; $20,000.
33.e. $90,000; $0.
34. Marie dividend income $145,000, $15,000 reduces basis in stock and capital gain $125,000 on sale; Juan dividend $45,000 and $115,000 reduction in basis.
35.a. $20,000; ($20,000).
35.b. No effect; ($27,000).
35.c. No effect; ($7,500).
35.d. No effect; ($43,000).
35.e. No effect; ($8,500).
35.f. $25,000; $0.
36.a. No effect; ($40,000).
36.b. ($30,000); $26,000.
36.c. $50,000; $150,000.
36.d. $3,000; $7,000.
36.e. $30,000; no effect.
36.f. ($12,000); $9,600.
36.g. No effect; ($2,400).$175,000.
36.h. ($80,000); $30,000.
36.i. No effect; $60,000.
37.a. $125,000.
37.b. $175,000.
37.c. Reduces $170,000.
38. $25,000 dividend and $10,000 return of capital.
39. Pintail recognizes gain $85,000 and E & P reduced $110,000; Niro taxable dividend $110,000 and basis equipment $130,000.
42.a. Dividend income $10,000, dividends received deduction $8,000, basis $60,000 in land.
42.b. $40,000.
43. Return of capital $40,000.
44. Taxable dividend $70,000 each; $210,000.
45. $5,500 long-term capital gain.
46. Long-term capital gain on sale $1,319.40 and basis new stock $4,271.40.
47.a. 655 shares.
47.b. 550 shares.
47.c. 675 shares.
48.a. Dividend income of $60,000.
48.b. Attaches to Vulcan’s basis.
48.c. $140,000.
49. Long-term capital gain of $70,000.
50.a. No.
50.b. Yes.
50.c. No.
51.a. Lori dividend income of $400,000; Swan reduces E & P by $400,000; Roberta capital gain of $375,000.
51.b. Roberta capital gain of $375,000; Swan reduces E & P by $350,000.
52. Red $300,000 gain recognized; E & P reduced by $1,000,000; estate $100,000 loss on sale.
53. Jorge long-term capital gain of $590,000; Tia and Gabriel dividend of $300,000, stock basis reduced to $10,000.
54. E & P reduced by $135,000; redemption expenses not deductible.

DISCUSSION QUESTIONS

1. At least six factors impact the tax treatment of corporate distributions. These factors are:

   - The availability of earnings to be distributed.
   - The basis of the stock in the hands of the shareholder.
   - The character of the property being distributed.
   - Whether the shareholder gives up ownership in return for the distribution.
   - Whether the distribution is liquidating or nonliquidating in character.
   - Whether the assets distributed are subject to any liabilities or whether the shareholder assumes any liabilities in the distribution.

   pp. 18-2, 18-11, and 18-12

2. "Earnings and profits" is the factor that fixes the upper limit on the amount of dividend income shareholders recognize as a result of a distribution from the corporation. It represents the corporation's economic ability to pay a dividend without impairing its capital. "Earnings and profits" is similar to the accounting concept of "retained earnings." However, E & P and retained earnings often are not the same. For example, a stock dividend which decreases the retained earnings account does not decrease E & P. E & P is increased for all items of income. It is decreased for deductible and nondeductible items, such as capital losses, income taxes, and expenses incurred to produce tax-exempt income. p. 18-3 and Concept Summary 18-1

3. The accounting methods employed when computing E & P are considerably more conservative than the methods allowed when computing the income tax. First, rather than allowing the taxpayer to carry forward NOLs, capital losses, and charitable contributions, these deductions are accelerated to the year realized. Second, the computation of E & P does not allow use of the installment method. Third, more conservative depreciation methods are used—in particular, ADS depreciation rather than MACRS is mandated and no additional 30 percent first-year depreciation is allowed. A portion of § 179 expense is deferred when computing E & P (only 20% of the expense is allowed as a deduction each year over a five-year period). A variety of other more conservative accounting methods are required when computing E & P (e.g., cost depletion, percentage of completion for long-term contracts, and capitalization and amortization of mining exploration and development costs and intangible drilling costs). pp. 18-4 to 18-6

4. a. If a distributing corporation has a deficit in accumulated E & P and a positive amount in current E & P, a distribution during the year is a taxable dividend to the extent of current E & P.

   b. If the corporation has a positive amount in accumulated E & P and a deficit in current E & P, a distribution either is a taxable dividend or a return of capital, depending on the resulting balance in E & P when current and accumulated E & P are netted. The accounts are netted at the date of distribution. If the resulting balance is zero or a deficit, the distribution is a return of capital. If a positive balance results, the distribution represents a dividend to that extent. For netting

purposes, current E & P is determined as of the date of the distribution by ratably allocating the loss over the entire year, unless the loss can be shown to have otherwise occurred.

c. If there is a deficit in both current and accumulated E & P, a corporate distribution is treated as a return of capital to the extent of the shareholder's basis in his or her stock. Any excess is a capital gain.

d. If there is a positive amount in both current and accumulated E & P, to the extent of the positive balance in both amounts, the distribution is a taxable dividend.

pp. 18-6 to 18-10 and Concept Summary 18-2

5. Gains and losses from property transactions generally affect the determination of E & P only to the extent they are recognized for tax purposes. Thus, for example, a gain on an involuntary conversion not recognized by the corporation because the insurance proceeds are suitably reinvested does not affect E & P. p. 18-4

6. This is not a valid assumption. Any current E & P (determined at the end of the year) is deemed to be available when the distribution occurs, on January 1. p. 18-9

7. A corporation may distribute a property dividend for various reasons. The shareholders could want a particular property that is held by the corporation. The corporation may be strapped for cash but does not want to forgo distributing a dividend to its shareholders. p. 18-10

8. Distributing automobile A would trigger a taxable gain of $7,000 for Crimson, while distributing C produces a nondeductible loss of $5,000. To preserve the loss on C and avoid recognizing a gain on A, Crimson should consider selling C and then distributing cash to the second shareholder. Crimson should also distribute automobile B because there will be no gain on distribution and no nondeductible loss. p. 18-11

9. Probably not, unless the corporation has some capital losses it cannot use. In the case of corporations, capital gains are taxed the same as ordinary income. See the discussion in Chapter 16.

10. If distributed property is subject to a liability or if a shareholder assumes a liability in a property distribution, the amount of the distribution is reduced by the liability, both for the shareholder and for purposes of determining E & P. For purposes of determining gain at the corporate level on distributions of appreciated property, a special rule applies when a property is subject to liabilities in excess of basis. In particular, the fair market value of distributed property is deemed to be not less than the amount of the liability. pp. 18-11 and 18-12

11.
- Is the distribution from corporate earnings?
- Is the distribution in partial or complete liquidation of Willet Corporation?
- Does the distribution qualify as a stock redemption for tax purposes?
- What is the tax basis of each of the shareholder's stock investment in Willet Corporation?
- What is the E & P of Willet Corporation?

- Has E & P been determined accurately for tax purposes?
- How will the distribution affect E & P for Willet Corporation?
- Another factor that is important is the nature of the shareholder. In the case of a corporate shareholder (Hawk Corporation in this situation), dividend treatment may be preferable to a capital gain result since the dividends received deduction is available to corporate shareholders.

pp. 18-2 to 18-12 and Chapters 16 and 19

12. Because of Jill's relationship with Becky, the IRS may argue that any excessive compensation paid to Jill or Becky is properly treated as a constructive dividend. Imputed interest on the loan to Becky may also be treated as dividend income. The following issues are relevant.

    - Are the salary payments to Becky and Jill reasonable?
    - What are Becky's qualifications and Jill's qualifications?
    - What are the nature and scope of Becky's work and Jill's work?
    - How does the overall salary paid to Becky and Jill compare with gross and net income?
    - What is the corporation's salary policy towards all employees?
    - Was the advance to Becky a bona fide loan?
    - Was it evidenced by a written instrument?
    - Was collateral or other security provided for the advance?
    - What is Becky's financial capacity to repay the loan?
    - How did Becky use the proceeds of the loan?
    - What is Tan's dividend paying history?
    - What is the amount of "imputed interest" on the loan?

    p. 18-13

13. a. The determination of the reasonableness of compensation paid to an employee who is not a shareholder but is related to the sole owner of the corporate-employer should be made in the same manner as that for salary paid the shareholder-employee. The degree of relationship between the sole owner of the corporation and the employee should be considered initially to determine if, in essence, the salary could be considered as having been paid to the owner. If so, the same factors used to determine the reasonableness of salary paid to the owner should be used to determine the reasonableness of salary paid to the related employee.

b. That the employee-shareholder never completed high school should be relevant only with respect to the nature and scope of the employee's work. Is education beyond high school required for the type of work performed by the employee-shareholder and the salary received for such work?

c. The fact that the employee-shareholder is a full-time college student might well cause any salary paid to be deemed excessive.

d. If the employee-shareholder was underpaid during the formative period of the corporation, this is evidence of reasonableness of the compensation if a portion thereof is for service rendered in prior years.

e. If a corporation has substantial E & P and pays only a nominal dividend each year, a constructive dividend may be found.

f. Year-end bonuses would be vulnerable to constructive dividend treatment, particularly if they are related to profit for the year, are paid only to shareholder-employees, and are determined at year-end on an arbitrary basis.

pp. 18-15, 18-32, and Example 42

14. Seagull's concerns may be misplaced because corporate shareholders are entitled to a dividends received deduction. In the present case, Seagull and Condor will each receive an 80% dividends received deduction because they each own 50% of the corporation. Since there may be other benefits conferred by the corporate form that are not available to partnerships (e.g., limited liability, easier access to the capital markets, ease of ownership transfer, etc.), it may be that the small tax on dividends faced by the corporations will be outweighed by non-tax factors.

    If Seagull and Condor were individuals, the dividends received deduction would not be available, so the double tax issue takes on added relevance.

    See discussion of the dividends received deduction in Chapter 16.

15. The salaries paid to Sam and Jennifer are vulnerable to constructive dividend treatment since neither shareholder appears to have earned them.

    There is also a problem regarding the $400,000 salary payment to Walter. Why is he receiving $350,000 more than Richard when it appears they share equally in the operation of the corporation? Although Walter is not a shareholder, his relationship to Sam and Jennifer is enough of a tie-in to raise the unreasonable compensation issue.

    Peregrine Corporation has distributed only one small dividend during the past ten years although it has substantial E & P. Given the dividend history and the salary disparities, the IRS might successfully argue that all of the salary paid to Sam and Jennifer is unreasonable compensation and that $350,000 of the salary paid to Walter is unreasonable.

    Example 42

16.
    - If Brown redeems Leona's shares, the remaining shareholders, Jacob and Ivan, are not required to use their own funds to purchase the stock.

- If Brown redeems Leona's shares, Jacob and Ivan will be the only remaining shareholders, thereby possessing total control of the corporation. Other, outside parties will not acquire an ownership interest.

- If Brown makes the purchase, no effort will be required to develop or cultivate an outside market for Leona's interest.

pp. 18-20 and 18-33

17. Kanisha's redemption failed to qualify for sale or exchange treatment and was instead taxed as a dividend at her marginal tax rate (i.e., $7,720 = 38.6% X $20,000). Susan's redemption, however, satisfied the terms of one of the qualifying redemption provisions and was taxed at the more favorable tax rate for long-term capital gains. That is, $3,000 = 20% X [$20,000 (amount realized) – $5,000 (basis in shares)]. Example 25

18. The basis of property received in a qualifying stock redemption will be its fair market value, determined as of the date of the redemption. p. 18-20

19. The tax treatment accorded a stock redemption is determined by the Internal Revenue Code, not by state law. A corporate distribution treated as a stock redemption under state law may not satisfy any of the qualifying stock redemption provisions of the Code. p. 18-21

20. For purposes of the family attribution rules, "related parties" include the spouse, children, grandchildren, and parents of the individual. Exhibit 18-1

21. Attribution *from* entities applies in the following manner. Stock owned by a partnership is deemed to be owned by a partner to the extent of the partner's proportionate interest in the partnership. Stock owned by a corporation is deemed to be owned proportionately by a shareholder owning 50% or more of the corporation's stock. Finally, stock owned by an estate or trust is deemed to be owned by a beneficiary or heir to the extent of the beneficiary or heir's proportionate interest in the estate or trust.

    Attribution *to* entities applies in the following manner. Stock owned by a partner is deemed to be owned in full by a partnership. Stock owned by a 50% or more shareholder in a corporation is deemed to be owned in full by the corporation. Finally, stock owned by a beneficiary or heir of an estate or trust is deemed to be owned in full by the estate or trust.

    Exhibit 18-1

22. The basis attaches to the shareholder's remaining stock basis or, if that shareholder has no remaining direct stock ownership, to stock the shareholder owns constructively. p. 18-24 and Example 32

23. To qualify as a not essentially equivalent redemption, the distribution must result in a "meaningful reduction" in the shareholder's interest in the corporation. A decrease in the shareholder's voting control appears to be the most important factor in determining whether the "meaningful reduction test" has been satisfied. Also considered are decreases in the shareholder's right to share in corporate earnings or to receive corporate assets upon liquidation. The meaningful reduction test cannot be satisfied if the shareholder continues to have a controlling interest (i.e., more than 50%) in the corporation after the redemption. The stock attribution rules apply in determining a

shareholder's ownership interest in the corporation before and after the redemption. The meaningful reduction test applies regardless of whether common stock or preferred stock is redeemed. pp. 18-22 and 18-23

24.
- Whether the transfer of Polly's property to Flycatcher Corporation qualifies as a nontaxable exchange under § 351.
- Polly's basis in her stock.
- Whether the redemption qualifies for sale or exchange treatment.
- Whether Polly is related to any shareholder of Flycatcher Corporation.
- If Polly is related to a shareholder of Flycatcher, will she continue as a director of Flycatcher or as a consultant to the corporation?
- What is Flycatcher's E & P at the time of the distribution?
- Whether Flycatcher has a recognized gain (or unrecognized loss) as a result of the property distribution.
- What is the effect of the distribution on Flycatcher's E & P?
- Whether Flycatcher incurred any (nondeductible) redemption expenditures as a result of the distribution.

pp. 18-25, 18-26, 18-28 and 18-29, and Chapter 17

25. Section 303 provides for sale or exchange treatment without regard to the stock attribution rules. However, a redemption to pay death taxes qualifies only to the extent of the sum of the estate's death taxes and funeral and administration expenses. A redemption in excess of those expenditures would be subject to the attribution rules. p. 18-26

26. The estate cannot qualify for a redemption to pay death taxes. Section 303 is not available because the value of the Violet Corporation stock in Yolanda's gross estate does not exceed the 35% of adjusted gross estate threshold ($500,000 ÷ $1,800,000 = 27.8%). pp. 18-26 and 18-27

27.
- Valuation of Angie's estate. Chapter 26
- Whether the executor should elect the alternate valuation date. Chapter 26
- Whether Angie's lifetime gifts to Ann included stock in Bluebird Corporation and, if so, the facts surrounding that transfer (e.g., dates, motivation).
- Whether a redemption of the estate's shares in Redbird Corporation will qualify under § 303.
- Whether a redemption of the estate's shares in Bluebird will qualify under § 303 (redemption to pay death taxes) or § 302 (complete termination redemption).
- If a redemption of Bluebird stock is advantageous, whether noncash property should be distributed in the redemption and, if so, which property.

- Whether Ann should purchase the estate's shares in Bluebird.
- Effect of Angie's lifetime gifts for her estate as to the unified tax credit. Chapter 26
- Marital and other estate deductions. Chapter 26
- Due date of estate tax return. Chapter 26
- Income tax return for estate. Chapter 27

28. Corporate distributions in redemption of stock are governed under § 311. That provision provides that gains, but not losses, are recognized on the distribution of noncash property when the property's fair market value differs from its basis. As such, the distribution of Property A would result in an $18,000 recognized gain [$30,000 (fair market value) – $12,000 (basis)] to Indigo. The $6,000 loss inherent in Property B [$30,000 (fair market value) – $36,000 (basis)] would not be recognized on the distribution of that property. Indigo could distribute the cash, as neither gain nor loss is recognized by Indigo on a cash distribution. However, a sale of Property B to recognize the $6,000 loss and a distribution of the sales proceeds to Linda produces more favorable results. (To avoid the related party loss disallowance rules of § 267, the sale must not be to Linda.) p. 18-28

PROBLEMS

29. Kelly and Laura have ordinary dividend income of $80,000 each {[$110,000 (Mallard Corporation's accumulated E & P) + $50,000 (Mallard Corporation's current E & P)] ÷ 2}. The remaining $40,000 of the $200,000 distribution reduces the basis (up to $20,000 each) in the shareholders' stock in Mallard Corporation with any excess treated as a capital gain. Kelly has a reduction in stock basis from $13,000 to zero and a capital gain of $7,000. Laura reduces her basis from $30,000 to $10,000. Example 1

30. a. Cardinal reports the $400,000 dividend as taxable income but has a dividends received deduction under § 243 of $280,000 (70% X $400,000). None of the other items affect taxable income. Thus, taxable income is $370,000 ($250,000 + $400,000 dividend – $280,000 dividends received deduction).

    b. Cardinal Corporation's E & P as of December 31 is $770,000, computed as follows: $90,000 (beginning balance in E & P) + $370,000 (taxable income) + $280,000 (dividends received deduction) + $60,000 (tax-exempt interest) – $30,000 (interest on indebtedness to purchase tax-exempt bonds).

    pp. 18-3 and 18-4

31. Buck reports $300,000 as a taxable dividend. The $550,000 gain on the sale of the land increases E & P by that amount in 2003. The E & P balance prior to the $300,000 distribution is $150,000 [$550,000 (gain on sale) – $280,000 (accumulated deficit) – $120,000 (current year deficit)]. Current E & P before the distribution is $430,000 [$550,000 (gain on sale) – $120,000 (current year deficit)]. Since there is adequate current E & P, the entire distribution is a dividend. pp. 18-4, 18-9, and Example 6

32.

	Amount Taxable	Return of Capital	
a.	$ 70,000	$60,000	Taxed to the extent of current E & P.
b.	$140,000	$70,000	Accumulated E & P and current E & P netted on the date of distribution.
c.	$150,000	$ -0-	Taxed to the extent of current and accumulated E & P.
d.	$ 80,000	$50,000	Accumulated E & P and current E & P are netted on the date of distribution. There is a dividend to the extent of any positive balance.
e.	$100,000	$30,000	When the result in current E & P is a deficit for the year, the deficit is allocated on a pro rata basis to distributions made during the year. On June 30, E & P is $100,000 [current E & P is a deficit of $20,000 (i.e., 1/2 of $40,000) netted with accumulated E & P of $120,000].

pp. 18-6 to 18-10

33.

	Amount Taxable	Capital Gain	
a.	$120,000	$10,000	Taxed to the extent of current E & P. Capital gain to extent distribution exceeds E & P plus stock basis.
b.	$100,000	$ -0-	Taxed to the extent of current and accumulated E & P.
c.	$ 70,000	$ -0-	Taxed to the extent of current E & P.
d.	$ 50,000	$20,000	Accumulated E & P and current E & P are netted on the date of distribution. There is a dividend to the extent of any positive balance.
e.	$ 90,000	$ -0-	When the result in current E & P is a deficit for the year, such deficit is allocated on a pro rata basis to distributions made during the year. Thus, on June 30, current E & P is a deficit of $80,000 (i.e., 1/2 of $160,000). This is netted with accumulated E & P of $210,000 to cause all of the distribution to be taxed.

pp. 18-6 to 18-10

34. The $90,000 in current E & P is allocated on a pro rata basis to the two distributions made during the year; thus $45,000 of current E & P is allocated to Marie's distribution and $45,000 is allocated to Juan's distribution. Accumulated E & P is applied in chronological order beginning with the earliest distribution. Thus, the entire accumulated

E & P balance of $100,000 is allocated to Marie's distribution. As a result, $145,000 ($100,000 AEP + $45,000 current E & P for one-half of the year) of Marie's July 1 distribution is taxed as dividend income. The remaining $15,000 of the $160,000 distribution reduces Marie's stock basis to $25,000 ($40,000 original basis – $15,000 recovery of capital). Marie then recognizes a capital gain of $125,000 on the sale of the stock [$150,000 (sales price) – $25,000 (remaining stock basis)]. Of the $160,000 distributed to Juan, $45,000 will be treated as a dividend. The remaining $115,000 will reduce Juan's stock basis to $35,000 [$150,000 (original cost) – $115,000 (reduction in basis from the distribution)]. pp. 18-6 to 18-10

35.

	Taxable Income Increase (Decrease)	E & P Increase (Decrease)
a.	$20,000	($20,000)
b.	No effect	($27,000)
c.	No effect	($ 7,500)
d.	No effect	($43,000)
e.	No effect	($ 8,500)
f.	$25,000	$ -0-

Note: E & P is not increased in f. because the $25,000 has already been included in taxable income. The realized gain is not an increase in E & P, only the recognized gain that is included in taxable income.

Concept Summary 18-1

36.

	Taxable Income Increase (Decrease)	E & P Increase (Decrease)	
a.	No effect	($ 40,000)	*
b.	($30,000)	$ 26,000	**
c.	$50,000	$150,000	
d.	$ 3,000	$ 7,000	***
e.	$30,000	No effect	
f.	($12,000)	$ 9,600	†
g.	No effect	($ 2,400)	††
h.	($80,000)	$ 30,000	†††
i.	No effect	$ 60,000	

* While the related party loss is not deductible under the income tax, it must be subtracted from E & P.

** Although intangible drilling costs are deductible in full under the income tax, they must be amortized over 60 months when computing E & P. Since $500 per month is amortizable ($30,000/60 months), $4,000 is currently deductible for E & P purposes ($500 X 8 months). Thus, of the $30,000 income tax deduction, $26,000 must be added back to E & P ($30,000 – $4,000 deduction allowed).

*** The receipt of a $10,000 dividend will generate a dividends received deduction of $7,000. The net effect on taxable income is an increase of $3,000. For E & P purposes, the dividends received deduction must be added back.

† Only 20% of current-year § 179 expense is allowed for purposes of E & P. Thus, 80% of the amount deducted for income tax purposes is added back.

†† In each of the four succeeding years, 20% of the § 179 expense is allowed as a deduction for E & P purposes.

††† Only ADS straight-line depreciation reduces E & P; thus, E & P is increased by $30,000, which is the excess of MACRS depreciation taken over the amount allowed under ADS.

Concept Summary 18-1

37. a. Dividend income to Azure is $125,000 [$175,000 (fair market value of the property) – $50,000 (liability assumed)]. The amount taxed to Azure is reduced by the dividends received deduction.

b. Azure's basis in the property is $175,000.

c. The distribution reduces Pearl's E & P account by $170,000 [$220,000 (adjusted basis of the property) – $50,000 (liability assumed by Azure)].

pp. 18-10 to 18-12

38. To determine the taxability of the $35,000 distribution, the balance of both accumulated and current E & P as of July 1 must be determined and netted. This is necessary because of the deficit in current E & P. One-half of the $30,000 loss, or $15,000, reduces E & P to $25,000 as of July 1 ($40,000 – $15,000). Thus, of the $35,000 distribution, $25,000 is taxed as a dividend and $10,000 represents a return of capital. Example 11

39. Pintail Corporation recognizes a gain of $85,000 on the distribution. Pintail's E & P is reduced by $110,000 [$130,000 (fair market value) – $20,000 (liability)]. Niro has a taxable dividend of $110,000 [$130,000 (fair market value) – $20,000 (liability)]. The basis of the equipment to Niro is $130,000. pp. 18-10 to 18-12

40.
- What basis do Cybil and Sally have in their stock in Copper Corporation after their initial transfers for stock?
- Does Sally's transfer qualify under § 351 of the Code as a nontaxable exchange?
- How is Copper Corporation taxed on the property distribution to Cybil?
- How do the distributions to Cybil and to Sally affect Copper's E & P?
- How will Cybil and Sally be taxed on the distributions?
- What is Cybil's basis in her stock when she sells it to Dana?
- How are Cybil and Dana taxed on the $80,000 distribution to each?

pp. 18-2 to 18-12 and Chapter 17

41. a. The result of this transaction is, in effect, a realized loss of $15,000 (the difference between basis of $33,000 and fair market value of $18,000) and a constructive dividend of $13,000 (the difference between the $18,000 fair market value and the $5,000 paid for the parking lot). Due to the application of § 267, Redwing cannot recognize the realized loss. However, the loss does reduce Redwing's E & P. The constructive dividend also reduces E & P. Thus, E & P is

reduced by $28,000 (the sum of the $15,000 disallowed loss and the $13,000 constructive dividend).

b. The loan to Royce will generate imputed interest since no interest was charged. The amount of imputed interest will be $9,000 ($200,000 X 9% X 1/2 year). This amount will be deemed paid as interest from Royce to the corporation. The deductibility of the interest by Royce will depend upon how the loan proceeds are used. Redwing will have taxable interest income of $9,000. Finally, Redwing will be deemed to pay a dividend to Royce equal to the amount of interest. Redwing's E & P will be increased by the amount of interest income and reduced by the amount of deemed dividend payment.

c. Bargain rentals create constructive dividends to shareholders. In the present case, the amount of constructive dividend to both Mike and Royce equals the fair rental value of the yacht. Thus, both shareholders will receive dividend income of $30,000 ($7,500 X 4 weeks) and Redwing's E & P will be reduced by the same amount.

d. The $7,000 excess amount ($20,000 – $13,000) paid to Mike by Redwing over the fair rental value of the equipment will be treated as a constructive dividend taxable to Mike. The dividend will also reduce Redwing's E & P.

pp. 18-13 to 18-16

42. a. Verdigris Corporation has dividend income of $10,000 [$60,000 (fair market value of the land) less $50,000 (liability on the land)]. The $10,000 is subject to the dividends received deduction under § 243 of $8,000, so that only $2,000 is taxed to Verdigris Corporation. Verdigris Corporation has a basis of $60,000 in the land.

b. Rust Corporation may not deduct the loss on the land. Its E & P is reduced by $40,000, the $90,000 basis of the land (which is greater than the fair market value) less the $50,000 liability on the land.

Examples 13 and 19

43. The shareholder has a return of capital of $40,000. The $40,000 reduces the basis in the Bunting Corporation stock; any excess over basis is capital gain. There is no taxable dividend because the accumulated E & P account is brought up to date on the date of the sale. On the date of the sale, E & P is a negative $10,000 [$175,000 (beginning balance in accumulated E & P) – $175,000 (existing deficit in current E & P from sale of the asset) – $10,000 (one-half of $20,000 negative E & P *not* related to asset sale)]; thus, the $40,000 distribution constitutes a return of capital. Generally, deficits are allocated pro rata throughout the year unless the parties can prove otherwise. Here the shareholder can prove otherwise. {If the $195,000 deficit in E & P were prorated throughout the year, there would have been a taxable dividend of $40,000 because E & P would have a positive balance of $77,500 [$175,000 (beginning balance in accumulated E & P) – $97,500 (one-half the $195,000 deficit for the year)]}. Examples 11

44. Indigo Corporation and Lucy each have a taxable dividend of $70,000. Tanager Corporation's current E & P is $180,000; thus, the entire distribution is a taxable dividend even though Tanager has no accumulated E & P. Indigo Corporation is entitled to a dividends received deduction of $56,000 (80% X $70,000) because it owns more

than 20% of the stock in Tanager Corporation. Thus, Indigo is only taxed on $14,000. Because Lucy is an individual, she pays tax on the entire dividend.

To determine Tanager Corporation's accumulated E & P at the end of the year, its current E & P ($180,000) is first reduced by the amount of the distributions ($140,000). The remaining $40,000 is then netted against the accumulated E & P deficit of $250,000, leaving a deficit of $210,000 as of January 1 of the following year.

pp. 18-6 to 18-10

45. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

February 20, 2003

Sarah Beckert
1822 N. Sarnoff Rd.
Tucson, AZ 85710

Dear Ms. Beckert:

This letter is in response to your question with respect to your sale of the Grebe Corporation stock you received as a nontaxable stock dividend. Our conclusion is based upon the facts as outlined in your February 10 letter. Any change in facts may cause our conclusion to be inaccurate.

You paid $10,000 for 3,000 shares of stock in Grebe Corporation two years ago. Last year, a nontaxable stock dividend of 1,000 additional shares in Grebe Corporation was received. The 1,000 shares were sold in the current year for $8,000. Your gain on the sale of the 1,000 shares is determined by subtracting your basis in the shares sold from the sales price. The tax basis in the 1,000 shares is determined by dividing the $10,000 cost of the original 3,000 shares by 4,000 (to include the 1,000 new shares). Your basis then would be $2.50 per share ($10,000 ÷ 4,000). Your gain of $5,500 would then be computed as follows: [$8,000 (selling price) – $2,500 (tax basis in the 1,000 new shares)]. The $5,500 gain on the sale is a long-term capital gain. The gain is long term because you have held your original Grebe stock for more than one year.

Should you need more information or need to clarify our conclusion, do not hesitate to contact me.

Sincerely yours,

Jon S. Davis, CPA
Partner

TAX FILE MEMORANDUM

February 15, 2003

FROM: Jon S. Davis

SUBJECT: Sarah Beckert

Today I conferred with Sarah Beckert regarding her letter to me dated February 10. Two years ago, Ms. Beckert purchased 3,000 shares of Grebe Corporation for $10,000. Last year, she received a nontaxable stock dividend of 1,000 additional shares in Grebe. She sold the 1,000 shares this year for $8,000. She asked me to determine the tax consequences of the stock sale.

At issue: How is the gain on the sale of shares of stock received as nontaxable stock dividends determined and how is it taxed?

Conclusion: The shareholder's basis in the original 3,000 shares, $10,000, is reallocated to the 4,000 shares she held after receiving the nontaxable stock dividend. Her basis per share after the stock dividend is $2.50 per share ($10,000 ÷ 4,000 shares). Her gain on the sale of the 1,000 shares is therefore $5,500 [$8,000 (selling price) – $2,500 (basis in 1,000 shares)]. The gain is a long-term capital gain because the holding period of the original shares tacks on to the shares received as a nontaxable stock dividend.

pp. 18-17 and 18-18

46. Because the fair market value of the rights is 15% or more of the value of the old stock, Cindy must allocate her basis in the stock between the stock and the stock rights. Cindy allocates basis as follows:

Fair market value of stock: 200 shares X $100 =	$20,000
Fair market value of rights: 100 rights X $45 =	4,500
	$24,500

Basis of stock: $6,000 X $20,000/$24,500 = $4,898
Basis of rights: $6,000 X $4,500/$24,500 = $1,102
Basis per right: $1,102 ÷ 100 rights = $11.02

There is a capital gain on the sale of the rights of $1,319.40, computed as follows:

Selling price of 30 rights	$1,650.00
Less: Basis of 30 rights (30 X $11.02)	(330.60)
Long-term capital gain	$1,319.40

Basis of the new stock is $4,271.40, computed as follows:

70 rights X $11.02	$ 771.40
Additional consideration ($50 X 70 shares)	3,500.00
Basis of newly-acquired stock	$4,271.40

Holding period of the 70 new shares begins on the date of purchase.

Example 24

47. a. Beatrice owns 655 shares, 300 shares directly and 355 shares indirectly, in Silver. Beatrice constructively owns the stock of her husband (120 shares), daughter (80 shares), grandson (50 shares), and 70% of the 150 shares, or 105 shares, owned by Maroon Corporation.

b. The stock attribution rules do not apply to stock held by a corporation if the shareholder owns less than 50% of the stock in that corporation. Thus, Beatrice would only own 550 shares, 300 shares directly and 250 shares owned by her husband (120 shares), daughter (80 shares), and grandson (50 shares).

c. Beatrice would now own 675 shares in Silver, the 655 shares as computed in part a., above, plus 20 shares as a result of her 20% Yellow Partnership interest [100 (shares owned by Yellow Partnership) X 20% (Beatrice's interest in the partnership)].

Exhibit 18-1

48. a. All of the Hawk Corporation stock owned by Vulcan Corporation is deemed to be owned by Shonda. Therefore, Shonda must report the $60,000 as dividend income. The redemption does not qualify as a not essentially equivalent redemption. After the redemption, Shonda owns 53% of the stock of Hawk [95 (Vulcan shares deemed owned by Shonda) ÷ 180 (remaining outstanding shares in Hawk)]. Shonda still has the dominant control of Hawk; thus, there has not been a "meaningful reduction" in her interest in Hawk. Further, her remaining ownership interest fails the requirements for a disproportionate redemption or complete termination redemption. pp. 18-22 to 18-25 and Example 30

b. The basis in the 20 shares redeemed attaches to Vulcan's basis in the Hawk Corporation stock it owns. p. 18-23 and Footnote 37

c. Since the redemption is treated as an ordinary dividend distribution, Hawk's E & P is reduced to $140,000 ($200,000 – $60,000). p. 18-3

49. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

May 12, 2003

Lana Pierce
1000 Main Street
Oldtown, MN 55166

Dear Lana:

This letter is in response to your question concerning the tax consequences of the redemption of 200 shares of stock you own in Stork Corporation. You were paid $80,000 for the shares and you have a tax basis of $10,000 in the stock. The remaining shares are owned by two unrelated individuals. Our conclusion is based upon the facts as outlined in your May 5 letter. Any change in facts may cause our conclusion to be inaccurate.

You will have a long-term capital gain of $70,000 on the redemption. Stork Corporation redeemed 200 of the 300 shares you owned in the corporation. Prior to the redemption,

you had a 30% ownership in Stork Corporation (300 shares ÷ 1,000 shares outstanding). After the redemption, you have only a 12.5% ownership [100 (your remaining shares in Stork) ÷ 800 (remaining outstanding shares in Stork)]. Because, after the redemption, you owned less than 50% of the stock in Stork Corporation and less than 80% of your original ownership [12.5% is less than 24% (80% X 300 shares/1,000 shares)], the redemption qualifies for capital gain treatment.

Should you need additional information or need to clarify our conclusion, do not hesitate to call on me.

Sincerely,

Marilyn C. Jones, CPA
Partner

TAX FILE MEMORANDUM

DATE: May 8, 2003

FROM: Marilyn C. Jones

SUBJECT: Lana Pierce

Today I talked to Lana Pierce with respect to her May 5 letter. She received a cash payment of $80,000 from Stork Corporation (E & P of $350,000) in exchange for 200 of the 300 shares she owned in the corporation. The remaining shares are owned by two unrelated individuals. She wants to know the tax consequences of the redemption.

<u>At issue</u>: Will the stock redemption qualify for capital gain treatment or will the $80,000 be treated as a taxable dividend?

<u>Conclusion</u>: Lana Pierce has a long-term capital gain of $70,000. Lana's percentage ownership in Stork Corporation was 30% (300 shares/1,000 shares) before the redemption and 12.5% (100 shares/800 shares) after the redemption. Because the 80% and 50% tests set out in § 302(b)(2) are met, the stock redemption qualifies for capital gain treatment.

pp. 18-24, 18-25, and Exhibit 18-1

50. a. The redemption cannot qualify as a complete termination redemption. Jacque is deemed to own Monique's 800 shares or 67% (800/1,200) of the remaining shares outstanding. The family attribution waiver does not apply because Jacque holds a prohibited interest in Thrush Corporation (i.e., directorship) immediately after the redemption.

b. The redemption can qualify as a complete termination redemption. Monique's position as a director does not constitute a prohibited interest for Jacque. Thus, if the other requirements for the family attribution waiver are satisfied (e.g., Jacque files the required agreement with the IRS), the redemption completely terminates Jacque's ownership interest in Thrush.

c. The redemption cannot qualify as a complete termination redemption. To qualify for the family attribution waiver, the former shareholder cannot acquire a stock

ownership interest in the corporation (other than by bequest or inheritance) during the 10 years following the redemption.

pp. 18-25, 18-26, and Examples 35 and 36

51. a. With respect to the distribution, Lori would have ordinary dividend income of $400,000 and Swan Corporation would reduce its E & P by $400,000. As a result of the stock transaction, Lori would have a basis of $400,000 in the newly acquired 100 shares and become the sole shareholder of Swan. Roberta would have a capital gain of $375,000 [$400,000 (amount realized) – $25,000 (basis in stock)] on the sale. The stock transaction would not affect Swan.

b. The transaction would constitute a complete termination redemption and result in a capital gain of $375,000 [$400,000 (amount realized) – $25,000 (basis in stock)] to Roberta. Lori would become the sole shareholder as a result of the redemption. Swan would reduce its E & P by $350,000 [$700,000 (E & P at time of redemption) X 50% (interest redeemed)].

pp. 18-20, 18-25, 18-26 and 18-28

52. Red Corporation will recognize a $300,000 gain [$1,000,000 (fair market value) – $700,000 (basis)] on the distribution of the land to the estate. Red Corporation's E & P is reduced by $1,000,000 as a result of the distribution. The estate will recognize no gain [$1,000,000 (amount realized) – $1,000,000 (estate's basis in stock)] on the redemption and it will have a basis in the land equal to its fair market value, or $1,000,000. When it sells the land for $900,000, the estate recognizes a loss of $100,000. pp. 18-26 to 18-28

53. Jorge has a long-term capital gain of $590,000 [$700,000 (amount realized) – $110,000 (basis)]. Warbler Corporation's E & P is reduced by $300,000 [33.33% (interest redeemed) X $900,000 (E & P at time of distribution). Thus, Warbler's E & P at the time of the cash distributions is $600,000. The $400,000 distributions to Tia and Gabriel will be a taxable dividend of $300,000 each. The remaining $100,000 of each distribution will be treated as a return of capital, reducing the basis of Tia's and Gabriel's Warbler stock to $10,000 each. pp. 18-25, 18-26 and 18-28

54. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 5, 2003

Crane Corporation
506 Wall Street
Winona, MN 55987

Dear President of Crane Corporation:

This letter is in response to your questions concerning Crane Corporation's tax consequences arising out of a redemption of its stock. Crane Corporation had 1,000 shares of stock outstanding when it redeemed 150 shares for $200,000. The shareholder received sale or exchange treatment on the redemption. Crane had paid-in capital of $500,000 and E & P of $900,000 at the time of the redemption. As a result of the redemption transaction, Crane Corporation incurred $30,000 of accounting and legal

fees. Our conclusions are based upon the facts as outlined in your November 27 letter. Any change in facts may cause our conclusions to be inaccurate.

Crane Corporation would reduce its E & P in the amount of $135,000 as a result of the redemption. This represents a 15% decrease in the amount of the E & P corresponding to the 15% stock redemption. When a stock redemption results in sale or exchange treatment for the shareholder, the E & P account of a corporation is reduced in an amount not in excess of the ratable share of the E & P of the distributing corporation attributable to the stock redeemed. The $65,000 balance of the redemption distribution would reduce the paid-in capital of the corporation.

No deduction is allowed for expenditures incurred by a corporation in connection with the redemption of its stock. As such, none of the $30,000 of accounting and legal fees is deductible.

Should you need additional information or need to clarify our conclusions, do not hesitate to call on me.

Sincerely,

Astia Jackson, CPA
Partner

TAX FILE MEMORANDUM

DATE: December 2, 2003

FROM: Astia Jackson

SUBJECT: Crane Corporation

Today I talked to the President of Crane Corporation with respect to its November 27 letter. Crane Corporation had 1,000 shares of stock outstanding. It redeemed 150 shares for $200,000, when it had paid-in capital of $500,000 and E & P of $900,000. The redemption qualified for sale or exchange treatment for the shareholder. Crane incurred $30,000 of accounting and legal fees with respect to the redemption transaction.

At issue: What is the reduction in Crane Corporation's E & P as a result of the redemption? Also, are the redemption expenditures deductible by Crane?

Conclusion: Under § 312(n)(7), the E & P account of a corporation is reduced by a qualifying stock redemption in an amount not in excess of the ratable share of the E & P of the distributing corporation attributable to the stock redeemed. Since Crane Corporation redeemed 15% of its stock, the reduction in E & P is 15% of the E & P account, or $135,000. Section 162(k) specifically disallows the deductibility of redemption expenditures. As such, none of the $30,000 of accounting and legal fees is deductible by Crane.

p. 18-28

NOTES