CHAPTER 4 - DISTRIBUTIONS OF CASH AND PROPERTY

Problems, page 119

4-1. This problem is based on Rev. Rul. 74-164 and is designed to take students through some of the provisions of §§301, 316 and 312. Section 61(a)(7) includes dividends in gross income. Section 301 and §316 define what constitutes a dividend.

4-1a. Under §301(a) the distribution is a dividend to the extent provided in §316. Although there are no accumulated earnings and profits under §316(a)(1), there are current earnings and profits, which are computed as of the end of the year. Consequently A will report a $5,000 dividend under §301(c)(1). Note that §316(a)(2) states that the dividend is calculated without regard to the amount of the earnings and profits at the time of the distribution. Of the remaining $15,000 distribution, $5,000 will reduce A's stock basis to $0 under §301(c)(2), and the remaining $10,000 will be treated as gain from the sale or exchange of the stock under §301(c)(3), generally resulting in a capital gain. Since all of the corporation's earnings and profits have been distributed, the earnings and profits account at the end of year 2 will be $0 for purposes of evaluating distributions made in year 3. See §312(a)(1).

You may want to ask students why the accumulated earnings and profits account as of the end of year 2 doesn't reflect a $15,000 deficit. After all, prior to the $20,000 distribution X Corp. had $5,000 of earnings and profits, and §312(a)(1) provides for a decrease in earnings and profits by the amount of money distributed, not the amount includable as a dividend. However, the parenthetical in §312(a) provides that earnings and profits cannot be decreased below zero by a distribution. (It states that earnings and profits "to the extent thereof" are decreased by the amount of money distributed.) This question emphasizes that a distribution cannot create (or increase) a deficit in earnings and profits.

You may want to follow this exercise by asking how there can ever be an earnings and profits deficit. A deficit may often be created, for example, when a corporation has net operating losses.

4-1b. This variation highlights the "nimble dividend" rule of §316(a)(2), providing that a dividend can be paid out of current earnings and profits. Even though there is an accumulated earnings and profits deficit, the results will be the same as in Problem 1a. You may want to point out that §316(a)(2) was originally enacted in 1936 as a shareholder relief provision when the undistributed profits tax was in existence. See Note 2 in text at page 115. The earnings and profits account as of the end of year 2 for purposes of evaluating any year 3 distributions will reflect the $15,000 deficit since all of the year 2 earnings and profits were distributed.

4-1c. In this variation, A would like to use the current deficit on the date of distribution to offset the accumulated earnings and profits, thereby reporting only a $5,000 dividend.

However Situation 1 in Rev. Rul. 74-164 along with §316(a)(2) make clear that the current earnings and profits account on the date of distribution is irrelevant. Consequently, the entire $20,000 will be a dividend fully includable under §§301(c)(1) and 61(a)(7). The $20,000 will reduce the accumulated earnings and profits account as of the end of year 2 to $0 for purposes of evaluating distributions in year 3

4-1d. This variation corresponds to Situation 4 of Rev. Rul. 74-164. Where there is a current earnings and profits deficit, it can be prorated so that the accumulated earnings and profits can be determined on the date of distribution. Accordingly, since the distribution occurs at mid-year, half of the current $20,000 deficit, or $10,000 can be prorated from the period from January 1 of year 2 through June 30 or year 2. That $10,000 deficit will wipe out $10,000 of the accumulated earnings and profits account, leaving accumulated earnings and profits of $5,000. The $20,000 cash distribution, then, will be treated in the same manner outlined in Problem 4-1a. For purposes of evaluating year 3 distributions, the accumulated earnings and profits account as of the end of year 2 will show a $10,000 deficit -- the prorated deficit attributable to the period from July 1 of year 2 through the year-end.

The last sentence of Treas. Regs. §1.301-1(b) suggests proration is inappropriate where the actual earnings and profits on the date of distribution can be determined -- in this case $15,000. If we were to use the actual accumulated earnings and profits on July 1 of year 2, X Corp. would have $15,000 of earnings and profits accumulated before January 1 of year 2 and another $15,000 accumulated between during the first half of year 2. Accordingly, the entire $20,000 would be a dividend under §§301(c)(1) and 316(a)(1). For purposes of evaluating distributions in year 3, X Corp. would have an accumulated earnings and profits deficit as of the end of year 2 of $25,000 -- $10,000 of undistributed earnings and profits as of July 1 of year 2 and a $35,000 deficit for the second half of year 2. Compared with the solution under Rev. Rul. 74-164, the result is a $15,000 greater dividend and a $15,000 increase in the accumulated earnings and profits deficit as of the end of year 2 for purposes of evaluating any year 3 distributions.

4-2. This problem is intended to expose students to the rudiments of calculating earnings and profits. You may want to point out that tax lawyers do not often calculate earnings and profits; we rely heavily on accountants. Nevertheless, it is useful to understand how particular transactions affect a corporation's earnings and profits. It might be helpful for students to think of the earnings and profits account as a crude yardstick for determining what a corporation has available for distribution to shareholders. As you proceed through this Problem, you may want to mention other earnings and profits adjustments that are not part of the Problem.

The solution follows the three-part process described in Note 3 at pages 116-117 of the text. You may want to first point out that the "net" figure has no significance whatsoever. You may also want to point out that earnings and profits and retained earnings are not synonymous. For example, stock dividends which reduce retained earnings have no effect on earnings and profits. See §312(d). Starting with taxable income, add certain items excludable from taxable income, add back certain deductions taken in arriving at taxable income and finally subtract certain items not deductible in arriving at taxable income. X Corp. has gross income of $52,000 ($27,000 operating income plus $20,000 dividend income plus $5,000 LTCG) under §61. The municipal bond interest is excludable under §103 and the contribution to capital is excludable under §118.

Since the adjusted gross income concept does not apply to corporations (see §62), we move directly to taxable income under §63(a). X Corp. has deductions of $40,000 ($15,000 of business expenses under §162 plus $6,000 of depreciation under §168 plus the $14,000 dividends-received-deduction under §243 plus $5,000 in capital losses under §165(a), §165(f), and §1211(a)). No deduction is permitted for the fines and kickbacks (see §§162(c) and (f)), or the interest incurred to purchase tax-exempt bonds (§265) and for capital losses in excess of capital gains (§1211(a) but §1212(a) permits a 3-year carryback and a 5-year carryforward).

On the $12,000 of taxable income, X Corp. accrues a federal tax liability of $3,600 (30% of $12,000). Note that X Corp. is an accrual basis taxpayer. This Problem assumes there are no state or local taxes.

Starting with the $12,000 of taxable income, we now add some items that were excludable from taxable income, but nevertheless provide X Corp. with the wherewithal to make distributions. We add the $9,000 municipal bond interest, thereby providing a $21,000 amount. You may also want to point out the all gain on installment sales goes into earnings and profits in the year of the sale regardless of the deferred recognition. See §312(n)(5). Since the capital contribution does not represent any kind of corporate earnings, it does not increase the earnings and profits account.

To this $21,000 amount, we add back some of the deductions that were permitted in calculating taxable income. In general these deductions are "artificial" in that they do not involve any corporate economic outlay. In §312(k), Congress has declared that the excess of accelerated over straight-line depreciation -- $4,000 in this Problem -- must be added back to earnings and profits even though deductible in calculating taxable income. Presumably, Congress decided that straight-line depreciation is a more accurate measure of actual depreciation (and therefore earnings available for distribution) while acceleration is allowed as an investment incentive. The dividends-received-deduction under §243 must also be added back -- in this Problem $14,000. While the §243 deduction is appropriate in determining the level of taxes paid, it does not represent any actual outlay by the corporation. (You may also want to point out that the $1,000 excess capital loss will be added back in whatever year the deduction is taken since the excess loss will be subtracted from earnings and profits in the current year although not deductible). The add-backs total $18,000 and when added to the $21,000 amount, earnings and profits is at $39,000 prior to the last step.

The last step is to deduct from this $39,000 amount certain outlays that were not deductible in calculating taxable income, but that deplete resources available for distribution. This adjustment would allow X Corp. to decrease earnings and profits by $13,600 ($7,000 for the fines and kickbacks plus $2,000 for the interest incurred to purchase tax-exempt bonds plus $1,000 of excess capital loss nondeductible under §1211 (Treas. Regs. §1.312-7(b)(1)) plus $3,600 for federal taxes accrued).

X Corp. has $25,400 of current earnings and profits.

Alternatively, earnings and profits could be computed more directly by adding together any amounts that increase X Corp.'s wealth (except the capital contribution) and reducing that sum by any amounts that decrease earnings and profits (taking into account §168(g)(2)). Earnings and profits are $25,400, or $61,000 (equal to $27,000 gross income plus $20,000 dividend income plus $9,000 municipal bond interest plus $5,000 long-term capital gain) minus $35,600 (equal to $15,000 wages and the like plus $7,000 fines and kickbacks plus $2,000 depreciation deduction plus $2,000 interest to purchase municipal bonds plus $6,000 capital losses plus $3,600 federal income tax).

Page 120: To demonstrate the significance of *General Utilities*, you might want to give the students a hypothetical along the following lines: Suppose X Corp. with ample earnings and profits has a piece of property with a basis of $20 and a fair market value of $100. If X Corp. sells the property and distributes the proceeds there will be a corporate-level tax on $80 of income and a dividend of $100 to the shareholders (assuming sufficient earnings and profits). If instead, X Corp. distributes the property to the shareholders who then sell, there will only be a shareholder-level tax on the distribution in the absence of §311(b). Note that on the sale, there will be no further gain since §301(d) gives the shareholders a fair market value basis in the distributed property. If X Corp. has no earnings and profits, the disparity is heightened. A corporate sale followed by a distribution will create earnings and profits so that the distribution will be taxed, at least in part, to the shareholders. However, if the distribution precedes the sale, the distribution may result in a non-taxable recovery of stock basis under §301(c)(2) and there will be no gain on the sale by the shareholders. See §301(d). Here the issue would be no tax versus two taxes -- one at the corporate and one at the shareholder-level.

While the Tax Reform Act of 1986 purports to eliminate the *General Utilities* doctrine it does so incompletely. Suppose in the example above that X Corp. has property with a basis of $100 and a fair market value of $20. If X Corp. sells the property, it will have a loss of $80 which can be used to offset income. §165. If X Corp. then distributes the $20 received on the sale, there will be a dividend (assuming sufficient earnings and profits). If instead X Corp. distributes the property to its shareholders who then sell it, the results will be different. Section 311 does not permit X Corp. to recognize a loss on the distribution. Moreover, §301(d) gives the shareholders a $20 basis in the property so that no loss will be recognized on the sale by the shareholders.

Arguably a full repeal of *General Utilities* would treat the distributed property as if it were sold to the shareholders. See §311(b). This language arguably should apply to both the gain and loss situation. Of course there is a potential for abuse in the loss situation where the shareholders and the corporation are related parties. But that is precisely why Congress enacted §267. Why not treat all distributions as if the property were sold to the shareholders and then let §267 take its course -- denying the recognition of certain losses but permitting others? The text at pages 122-123 considers that question.

Problems, pages 125-126

This problem is designed to focus primarily on repeal of *General Utilities* and the enactment of "new" §311(b), but also contains a healthy dose of §301 and the earnings and profits provisions. In part, it requires students to closely examine the Code.

4-3a. This problem highlights the importance of the *General Utilities* repeal in §311(b). If the distributed property has a $3,000 value, X Corp., the distributing corporation, recognizes no gain on the distribution, because the property basis is $3,000. B, the shareholder, will have no dividend income under §§301(c)(1) and 316, since X Corp. has no earnings and profits. Under §301(c)(2), B must reduce the X stock basis from $5,000 to $2,000. The distributed property will have a $3,000 basis under §301(d).

If the Service prevails and property is consider to have a $7,000 fair market, X Corp. will recognize a $4,000 gain under §311(b). The gain will be capital or ordinary depending on the nature of the property distributed. Disregarding the tax on the gain, the distribution will increase the earnings and profits of X Corp. by the recognized gain, or $4,000. With earnings and profits at $4,000, B will be have a $4,000 dividend under §301(c)(1) and will reduce his stock basis from $5,000 to $2,000. (Note that if B held the X stock for at least 61 days, the dividend income may be qualified dividend income.) B will take a $7,000 basis in the distributed property. After the distribution, X Corp.'s earnings and profits will be decreased by up to the fair market value --$7,000 -- of the distributed property. See §§312(b) and 312(a)(3). Note that the parenthetical in §312(a) prevents the reduction of earnings and profits below $0 on a distribution.

4-3b. Under §311(b)(2) and §336(b), X Corp. must treat the assumed (or taken subject to) liability as the amount realized. This is essentially a codification of the rule in *Tufts v. Commissioner*, 461 U.S. 300 (1983). Accordingly, X Corp. recognizes a $5,000 gain which increases X Corp.'s earnings and profits to $5,000. While §§311(b)(2) and 336(b) treat the distributed property as having a fair market value equal to the amount of the indebtedness for purposes of §311, for purposes of §301 the amount distributed is deemed to be $0. §301(b)(2). B has no dividend income, basis reduction, or gain under §301 and the basis of the distributed property is determined under §301(d) (*i.e.*, equal to its fair market value).

Determining the basis of the property in the hands of B depends on how the "son of *Tufts*" problem is resolved. Can B take an $8,000 basis even though the liability exceeds the fair market value of the property? See *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976). If the basis is restricted to fair market value under §301(d) (as literally appears to be the case), then a subsequent sale by B where the purchaser pays nothing but assumes the liability might result in a $1,000 taxable gain to B (if the full debt relief is counted in computing amount realized) even though B has nothing to show for it! Presumably, the *Crane* rule would be modified in this context.

What effect does the distribution have on the earnings and profits of X Corp.? Under §312(c) and Treas. Regs. §1.312-3 and -4, proper adjustment must be made for the liability. New regulations will be required to coordinate §312(b), §312(a) and §311(b)(2).

For example, fair market value as defined in §312(b)(2) should not be less than the liability assumed or taken subject to. Under the current version of Treas. Regs. §1.312-3 the earnings and profits will remain unchanged -- the expected $8,000 reduction is decreased by the $8,000 liability assumed or taken subject to. That leaves a $5,000 earnings and profits account under §312(b)(1).

4-3c. If the transaction is respected for tax purposes, there are some interesting results. X Corp. would avoid gain recognition under §311(b), since the transaction would be a sale. Under §453 the $4,000 gain would be deferred until the note was paid. B would avoid dividend treatment since the property was purchased rather than distributed. B's basis in the property would be $7,000 under §1012 and *Crane*. X Corp.'s earnings and profits would increase immediately by $4,000 under §312(n)(5).

The sale would avoid an immediate corporate-level and shareholder-level tax as compared with a distribution of the property. But you may want to point out that this different treatment results from two different transactions -- one a distribution the other the surrender (in the future) of $7,000 of cash for property.

When the note is paid, X Corp. will report a $4,000 gain and B will have $7,000 less than if the property were merely distributed.

Suppose B defaults on the note? If the default is not treated as if X Corp. distributed the note to B, under §61(a)(12) and Kirby Lumber, B should have $7,000 of ordinary income. X Corp. should have a $3,000 deduction under §166. If B and X Corp. are solvent, however, the Service would contend that X Corp should be deemed to distribute the note to B in which case X Corp. would have a $4,000 gain under §453B . *See* Treas. Regs. §1.301-1(m). Further, B might have dividend income (instead of $7,000 of ordinary income) with the dividend amount tied to X Corp.’s earnings and profits at that time. But even under the Service's view, X Corp. and B are better off than a straight distribution in the earlier year. X Corp. still ends up taxed on $4,000 and B on no more than $7,000, but the taxes are not paid until the “default” year. Note that if the sales year is still open in the “default” year, the Service might contend that the purported sale should be treated instead as a distribution of the property with the results noted in answer to problem 4-3a.

4-3d. Under §311(a) X Corp. is not entitled to deduct the $4,000 loss on the distribution. Moreover the distribution has no effect on X Corp.'s earnings and profits for purposes of evaluating the tax consequences to B. B will have a $3,000 dividend under §301(c) since X Corp. has $4,000 of earnings and profits. Following the distribution, X Corp.'s earnings and profits will be $0 under §312(a)(3). Note that earnings and profits cannot be reduced below $0 by a distribution. §312(a) (parenthetical).

If X Corp. could recognize the $4,000 loss deduction, B might have no dividend since the recognized loss would decrease current earnings and profits by $4,000 (by reducing X Corp.'s taxable income, the starting point for computing earnings and profits). Instead B would reduce his stock basis by $3,000 under §301(c)(2).

B takes a $3,000 basis in the distributed property. When it increases in value and is sold by B for $7,000, B must recognize a $4,000 gain. Note that if §267(d) applied, B would recognize $0 gain since the X Corp.'s unused loss could be used to offset the gain.

You might want to ask students why Congress does not permit X Corp. to recognize the loss subject to the rules of §267. To do so, Congress would have to amend §311 to treat all distributions as if the property were sold to the shareholders. If B were a controlling shareholder, X Corp. could not recognize the loss under §267(b)(2), but if B were, for example, a 25 percent shareholder, §267 would not otherwise bar the loss. If the corporation can sell property to a 25-percent shareholder and recognize the loss, why not allow loss recognition on a distribution? If §267 did apply and B were a controlling shareholder, the basis rule of §267(d) would allow B to offset any gain B realizes from an eventual sale up to the $4,000 disallowed loss. Thus a sale for $7,000 would not be taxable to B if §267 applied, but under current law, B would recognize a $4,000 gain. Note that if §267 applied, the distributing corporation and shareholder would have an incentive to undervalue the distributed property to minimize the shareholder's dividend.

4-3e. The taxpayer would like to aggregate the gain and loss property for purposes of §311(b) and §312(b). Does "property" mean aggregate property? If aggregation were permitted, X Corp. would recognize no gain, and B would have a $4,000 dividend on the distribution of property with an aggregate fair market value of $10,000. By way of analogy, §357(c)(1) allows a taxpayer to aggregate the basis of transferred property in determining if liabilities exceed basis.

However, Congress made its intent clear to require aggregation in §357(c)(1), and §311(b) lacks similar clear language. Thus, aggregation should not be permitted, just as it is not permitted under §1001. Separate treatment makes the most sense under the Code, because aggregation would circumvent the loss disallowance of §311(b), allowing loss to offset the gain.

X Corp. will recognize a $4,000 gain on the distribution of gain property under §311(b) and cannot recognize the loss on the distribution of the loss property. Disregarding the tax on the gain, X Corp.'s earnings and profits will increase from $4,000 to $8,000 under §312(b)(1) for purposes of evaluating the tax consequences to B. No adjustment is made at this point for the distribution of the loss property. B, who receives a $10,000 distribution under §301(b) has an $8,000 dividend under §301(c)(1) and takes a $3,000 basis in the loss property and a $7,000 basis in the gain property under §301(d). X Corp.'s earnings and profits will be $0 following the distribution under §312(a)(3) and §312(b)(2). Presumably the regulations when promulgated will treat each piece of property separately. This is the same issue raised by Problem 3 of Chapter 3.

4-3f. This problem revisits the Service's argument in *General Utilities*. There, the Service argued unsuccessfully that a corporation distributing appreciated property in satisfaction of a dividend declared in cash must recognize gain. Under cases such as *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940), the use of appreciated or loss property to satisfy a pecuniary obligation gives rise to gain (or loss). In *General Utilities*, the court determined that a cash dividend had not been declared.

With the repeal of *General Utilities*, the Service's argument becomes quite attractive when loss property is involved. Subject to §267, it would seem that X Corp. could recognize the $4,000 loss on the distribution which would wipe out X Corp.'s earnings and profits (by decreasing X Corp.'s taxable income). The result would be a loss for X Corp. and no dividend for B who would reduce his basis by $3,000.

Undoubtedly the Service would step the transactions together -- the declaration of a cash dividend and the satisfaction of the dividend with loss property -- concluding that X Corp. had declared a dividend of loss property with no loss permitted to X Corp.

4-3g/h. Problems 4-3g and 4-3h illustrate a "reverse" *Court Holding Co.* situation. In *Court Holding Co.*, the Service argued that a purported sale by a shareholder should be attributed to the corporation, which would then be deemed to distribute the proceeds. Here, the Service might argue that the purported sale by the corporation should be attributed to the shareholder.

If the sale is deemed made by X Corp. and not B (as is more likely the case in Problem 4-3g), the corporation can recognize a $4,000 loss which can offset other income. Moreover, the loss will decrease X Corp.'s earnings and profits by $4,000 (taxable income is decreased) down to $0 so that the distribution of the $3,000 proceeds will not constitute a dividend to B. §301(c)(1). Instead, B will reduce his stock basis. §301(c)(2).

If the sale is deemed made by B (as is more likely the case in Problem 4-3h), X Corp. will not recognize a loss on the deemed distribution of the loss property, and B will have a $3,000 dividend under §301(c)(1). B would take a $3,000 basis in the property and would have no gain or loss on the sale to P.

Whether the sale will or will not be attributed to B depends on how far the sales transaction has progressed. If B and P have signed the sales contract and X Corp. has declared the dividend, then last minute changes will probably be ineffective. However, if no dividend has been declared (or perhaps planned), X Corp. should be able to recognize the loss. In between, there is little certainty.

Problems, page 142

4-4. This Problem raises the issue discussed in the *Jaques* (page 136) and *Truesdell*, (page 141) cases — whether a corporate loan to a shareholder will be respected for tax purposes or will be treated as a constructive dividend. The facts of the Problem are intentionally vague. You may want to ask students to pretend that they are confronted with the facts of Problem 4-4 by a client. What questions would they ask the client in order to give an opinion as to whether the loan will be respected?

In these corporate loan situations, courts often follow a two-part analysis. First, they ask whether the purported loan is in substance a loan. If not (as in *Jaques*), then the loan proceeds will be treated as a distribution governed by §301(c). The mere fact that the loan does not bear an appropriate rate of interest does not automatically mean that the loan will not be respected for tax purposes. Indeed, §7872 shows that Congress recognizes that there is such a creature as a below-market interest rate loan. If the loan is respected, the second concern is whether the loan bears an appropriate rate of interest. If it does, there are no dividend consequences. If it does not, then there may be dividend consequences to the extent the corporation has made available to a shareholder a corporate asset (money) without charging rent (interest). If a corporation gives a shareholder the free, personal use of a corporate jet or hunting lodge, the shareholder has a constructive dividend equal to the fair market value of the free use. If the corporation gives a shareholder the free use of corporate money, the shareholder has a dividend equal to the fair market value of renting money, or interest.

Section 7872 has codified this principle. It is probably not appropriate to get bogged down in the details of §7872 in a corporate tax course. However, you can explain its application to this Problem by stating that §7872 assumes that a market rate of interest (in this case assume 10 percent) will be charged in arm's length transactions. Therefore, it is as if X Corp. not only made a $100,000 loan, but also distributed $10,000 to A to be used to pay the interest that §7872 deems to have been paid. The $10,000 is a dividend to A and is not deductible by X Corp. Section 7872 then deems A to have made a $10,000 interest payment to X Corp. If A can deduct the deemed interest payment but the dividend is qualified dividend income, A may enjoy a tax advantage: A may offset ordinary income with the deduction but be taxed at preferential rates on the dividend. X Corp. will have $10,000 of deemed interest income that is not offset by the nondeductible dividend distribution. The foregoing treatment is deemed to occur each year the loan is outstanding .

If there is distribution treatment either because the loan is recharacterized as a distribution or because the loan is treated as a loan and §7872 provides a dividend distribution, the distribution may or may not be characterized as a dividend depending on whether there are sufficient earnings and profits. Because X Corp. is a "start up" company with large R & D expenses, X Corp. may have little or no earnings and profits. If that is the case, then under *Truesdell* the deemed distribution will be a return of capital under §301(c)(2).

4-5. This problem is based on *Baumer* and §311(b). B may argue that the option to buy at fair market value has no value when distributed. Consequently, X Corp. would recognize no income since the basis and fair market value of the option would be $0 in year 1. B would have no income since the option had a fair market value of $0. §301(b). (Note that there is also an earnings and profits deficit). The exercise of the option is not a taxable event, but B would recognize a $2,000 gain if he sells the property for $3,000.

Under *Baumer* and §311(b), the Service may argue that the option has a positive fair market value which would produce gain recognition by the corporation and a dividend to B. When should the corporation recognize gain and B report a dividend? In year 1 when the option is distributed? If, for example, the option were deemed to be worth \$2,000 in year 1, X Corp. would recognize a \$2,000 gain but the \$2,000 increase in earnings and profits under §312(b) would only reduce the deficit to \$3,000 and therefore B would not be taxed on the \$2,000 distribution. Nevertheless, B would take a \$2,000 basis in the option under §301(d) which when added to the \$1,000 exercise price would give B a \$3,000 basis in the property. If B sold the property for \$3,000 there would be no further gain.

Note how arbitrary the \$2,000 value of the option is. Unless there is a market for such options the option might be worth practically nothing if the chances of the land appreciating are very low or worth a fortune if the chances of striking gold are great. For that reason, the Service or in some cases the taxpayer might argue for "open-transaction" treatment under *Burnet v. Logan*. If so, presumably the tax consequences of the distribution to X Corp. or B would be postponed until the option was exercised. At that time X Corp. would recognize a \$2,000 gain increasing the current earnings and profits from \$0 to \$2,000. B then would have a \$2,000 dividend under §301(c)(1) and have no further gain upon the sale of the property for \$3,000 since the \$2,000 basis in the option under §301(d) when added to the \$1,000 exercise price equals the \$3,000 amount realized on the sale.

Could the taxpayer argue that the "open-transaction" doctrine determines the amount of the distribution, but since the distribution took place in year 1, the \$5,000 deficit should apply thereby protecting B from dividend treatment? Success would be unlikely since under the open-transaction doctrine, gain is reported when it becomes known and not by amending an earlier return.

4-6. This Problem raises the issue of whether a purported loan between commonly held corporations will have dividend tax consequences to the common shareholder. The vague fact pattern can be used to elicit from students what questions they would ask a client in order to determine the dividend consequences of the transaction. Courts generally follow a two-part analysis. First, should the loan be respected? If so, there will be no dividend consequences. If not, courts then determine whether the transferring corporation (X Corp.) has any business reason for advancing the money to the recipient (Y Corp.). If there is a business reason, the common shareholder should not have dividend consequences. If there is no business reason, X Corp. will be treated as having made a distribution taxable under §301(c) to the common shareholder (A) who then will be treated as making a contribution to capital of Y Corp.

Applying the foregoing analysis to this Problem, students first should attempt to ascertain the validity of the loan. The factors in this analysis, which are discussed in *Jacques*, include interest rate, observation of loan formalities, and likelihood of repayment.

Assuming that the transaction is not respected as a loan, what business reasons would explain the transfer of funds? X Corp. would like to be able to show that it benefited directly from the transfer to Y Corp. (so that X Corp. is treated as acquiring an equity interest in Y Corp.). For example, if the restaurants are located in the same shopping mall, X Corp. might be able to show that Y Corp.'s restaurant brought more foot traffic into the mall resulting in more customers for X Corp. Or perhaps the continued viability of Y Corp. meant that X Corp. would realize savings on joint purchases of food or other restaurant supplies. Or perhaps X Corp. would realize some labor savings as long as Y Corp. remains viable since workers might perform services for both corporations. See *Schnallinger v. Commissioner*, T.C. Memo. 1987-9.

4-7. Given the facts of this problem, no part of any rent payment by X Corp. to its shareholder should be recharacterized as a dividend (or more generally, as a distribution taxable under §301). Since the rent was at all times a market rent, the payments by X Corp. were for possession and use of the land and were not made with respect to any shareholder's stock. Further, the rent payments did not diminish the corporation's treasury because the value going out in the form of rent payments was offset by the value coming in through enjoyment of the land.

There may, however, have been a dividend in year 5 when X Corp. constructed the building since part of that expenditure inured to X's shareholders. Was it commercially reasonable for X Corp. to build that building? If not, presumably some dividend occurred in year 5.

What if the stated rent due under the first lease was below fair market value to account for the future building? In that case, perhaps there was no dividend at any point. There has, of course, been an accession to wealth by the shareholders in their individual capacities, but that accession will be taxed to the shareholders in the form of the increased rent under the second lease. (Because §1019 gives the shareholders a zero basis in the building, rental payments received for it will not be offset in any part by depreciation). *Cf.* §1.61-8(c) (providing that when a lessee places improvements on real estate that are a substitute for rent, the improvements are rental income to the lessor).

Note that the shareholders will be taxed on the value of the building whether there was a dividend or not: if there was a dividend in year 5, they should be taxed then and take a positive basis in the building, while if there was no dividend in year 5, they should not be taxed then (or at the end of the first lease, see §109) but will have no depreciation to offset the subsequent, higher rent.

Why, they, does it matter whether there was a dividend or not? Timing is part of the answer, because dividend characterization gives the shareholders income in year 5 of the first lease while non-dividend characterization gives them income over the useful life of the building.

More importantly, though, if there was a dividend to the shareholders, then some part (the dividend part) of the corporation's expense in constructing the building should not be amortizable. Thus, the big issue in this case is the deductibility by X Corp. of a disguised dividend. Perhaps this explains the otherwise unbelievable (and unquestionably incorrect) holding in *Safeway Steel Scaffolds Co.* that some part of the rent under the second lease was a dividend despite the stipulation that the total rent was no more than the fair rental of the land plus building.

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4-8. This problem is intended to highlight the issues raised in *Waterman Steamship* and *Litton Industries*. If the transaction is respected, then X Corp. may be entitled to a deduction equal to the dividend received under §243 (*i.e*. therefore having no net income), has no gain on the sale and no gain when the debt is paid off (§301(d) provides a $3 million basis in the note). The Service may ignore the dividend and attempt to tax X Corp. on the $3 million gain on the deemed sale for $5 million. If X Corp. has the financial means to satisfy the note and the dividend is paid before X Corp. seeks or receives offers for the Y Corp. stock, in reliance on *Litton Industries*, the taxpayer may prevail. Note, however, that the distribution of a note, rather than cash or other assets that the purchaser doesn't want to acquire, may not satisfy the "business purpose" doctrine.

4-9. If Y Corp. borrowed $3 million from an unrelated third party and distributed those funds to X Corp., it is more likely that the distribution will be respected as separate from the sale, at least if the negotiations for the sale occur after the distribution. This question highlights a distinction between *Waterman Steamship* and *Litton Industries*. In the former case, unlike the latter case, it appeared that the distributing corporation could not have borrowed the principal amount of the distributed note from an unrelated third party. Thus, in the former case, the court was reluctant to treat the distribution and sale as separate steps for tax purposes, because it appeared that the buyer had to fund the note's payment.

If the note is guaranteed by X Corp. before the sale and by P Corp. after the sale, those guarantees raise the issue of whether Y Corp. could fund the repayment of the note, making it less likely that the distribution and sale will be treated as independent steps. *See Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972) (treating a guarantor as the debtor).