CHAPTER 6 – DISTRIBUTIONS OF STOCK

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6-1a. Part (i): If any shareholder has the election to receive cash or property in lieu of stock, then the stock dividend is taxable under §301 to all recipients. §305(b)(1). It does not matter whether one or more shareholders elect to receive cash. See Reg. § 1.305-2(a). Note that those shareholders who elect to receive cash will be taxed under §301 regardless of the applicability of §305.

Part (ii): The preferred shareholders wi11 be taxed directly under §301. The common shareholders might desire the deferral benefit of §302(a), but they will instead be taxed immediately under §301 by virtue of §305(b)(2). Their receipt of the preferred stock gives them an increase in the assets as well as in the earnings and profits of the corporation, see §305(b)(2)(B), and the cash distribution to the preferred shareholders satisfies the companion distribution requirement of §305(b)(2)(A). Under Regs. §1.305-3(b)(3) and (4), any distribution of property within 36 months of the stock dividend can constitute to required companion distribution. Accordingly, an 18 month delay should not suffice to protect the stock dividend. This problem is taken from Regs. § 1.305-3(e)(ex. 3).

Part (iii): The preferred shareholders receiving common stock will be taxed under §301 by virtue of §305(b)(4) because the distribution is not a mere increase in the conversion ratio. The common shareholders will be captured by §305(b)(2) because the preferred shareholders received "property" (i.e., common stock) pursuant to §305(b)(2)(A) and because the common shareholder increased their proportionate interest in the corporation. §305(b)(2)(B).

6-1b. Part (i): The holder of the class A common (M) will be taxed on the distribution of cash under §301. The holder of the class B common (N) will also be taxed under §301 pursuant to §305(b)(2) if he has experienced an increase in his proportionate interest in the assets or earnings and profits of the corporation, see §305(b)(2)(B). Since all shares participate ratably in current and liquidating distributions, N has enjoyed such an increase and accordingly will be captured by §305(b)(2). Note that the companion distribution requirement is satisfied by the distribution of cash to M.

If each class of stock were entitled to 50% of current and liquidating distributions, then the stock dividend to N does not increase his proportionate interest in the corporation, so that the stock dividend will be tax-free and he would have to allocate some of his basis in his old stock to his new stock pursuant to §307(a).

Part (ii): N's ownership of the corporation will drop from 100 of 200 shares (50%), to 75 of 175 shares (43%). N will fail to qualify for exchange treatment under §302(b)(2) because his post-redemption percentage of stock ownership is not less than 80% of his pre-redemption percentage ownership. However, N might qualify for exchange treatment under §302(b)(1), especially since the effect of the distribution was to transfer effective control of the corporation to M. See Rev. Rul. 75-502, cited at page 178 of the text. If N qualifies for exchange treatment on the redemption, then M cannot be taxable under §305. However, if N is subject to taxation under §301 by virtue of §302(d) then M falls within the language of §305(c). However, Regs. §1.305-3(e) (ex.10) provides that shareholders not participating in a redemption will not be subject to taxation under §305(c) if the redemption is "an isolated redemption and is not part of a periodic redemption plan." Thus, M should be safe. However, if the redemption is not an isolated redemption, M should be taxed on a deemed distribution of 33 1/3 shares of stock, since the ratio 133 1/3: 100 is the same as 100:75.

Part (iii): Both M and N will be taxed on the stock dividend pursuant to §305(b)(3). See example 1 of Regs. §1.305-4(b). Both M and N must allocate their basis pursuant to §307(a).

6-1c. N, as a holder of preferred stock, is taxed directly under §301. At issue is whether M, as a holder of common stock, is taxed under §301 pursuant to §305(b)(2). Section 305(b)(2) does not apply here because §305(b)(2)(B) is not satisfied: the holders of common stock have not increased their share of the earnings or assets of the corporation. See Regs. § 1.305-3(e)(ex. 2). Therefore, M will not be taxed on the stock dividend. §305(a). M must allocate his basis pursuant to §307(a).

If the preferred stock is convertible into common stock, the effect of the distribution on the holders of common stock is to increase their proportionate interests in the corporation *if* the terms of conversion are such that the holders of the preferred stock improve their position by converting. But note that the regulations assume for purposes of §305(b)(2) that the preferred is converted. Therefore, M will be taxed under §301 pursuant to §305(b)(2).

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6-2. The formation of Y Corp. by B and D is a §351 transaction. Both B and D receive both common and preferred stock of Y as part of the transaction, and such preferred stock will be tainted under §306(b)(3) if cash in lieu of the preferred stock would have been a dividend to any extent.

None of the Y common is tainted under §306. However, the Y preferred stock might be tainted under §306.

As to D, cash received in lieu of the preferred stock would have been taxed under §351(b), giving D exchange (and not dividend) treatment. Accordingly, D's preferred stock is not tainted.

As to B, if cash had been distributed in lieu of the preferred stock, the transaction would have been described in both §304 and §35l(b). Pursuant to §304(b)(3)(A), taxation under §304 takes priority. Accordingly, it must be determined whether such hypothetical cash would have been taxed as a dividend under §304.

B’s ownership of X Corp. prior to the transaction was 80 of 100 shares (80%). B’s ownership of X Corp. after the transaction is 64 (80% of 80) of 100 shares (64%) under §318(a)(2)-(3). Thus, B fails to qualify for exchange treatment under §302(b)(2). However, B might qualify under §302(b)(1). If so, then the cash would not have been taxable as a dividend to any extent, and none of the stock would be tainted by §306. However, if §302(b)(1) would not apply, B would have distribution treatment under §301 on this hypothetical redemption and, for computing the dividend component under §301(c)(l), the earnings and profits of X *and* Y are used, see §304(b)(2). Since X has positive earnings and profits, all of the preferred stock is tainted under §306(c)(3).

If B had received only a 50% interest in Y Corp., then his post-transaction ownership of X Corp. would have been 40 (50% of 80) shares of 100 (40%). Since B’s pre-transaction ownership of X had been 80%, B would have qualified for exchange treatment, under §302(b)(2), had cash been distributed in lieu of the preferred stock. Accordingly, there would be no §306 taint in this case.

6-3. Prior to the stock dividend, the common stock was worth $500 per share, or $100,000 total. Since 200 shares of preferred stock were distributed worth $200 per share (or $40,000 total), the value remaining in the common stock was $60,000, or $300 per share. Under §307(a), each shareholder's pre-dividend common stock basis must be allocated among the common and preferred stock in proportion to their relative fair market values. Both A and B had a $10,000 basis in their common stock prior to the stock dividend. Accordingly, their stock bases after the stock dividend are: $6,000 for the common stock ($60 per share) and $4,000 for the preferred stock ($40 per share). The preferred stock is tainted under §306(c)(1)(A).

6-3a. A is taxed on the sale of the preferred stock under §306(a)(1). If cash in lieu of the preferred stock had been distributed in 1986, there would have been a dividend under §301(c)(1) of $20,000. Since 200 shares of preferred A stock were distributed, each share's ratable share of that dividend amount is $100. Accordingly, the limitation of §306(a)(1)(A) applies to A's sale, limiting ordinary income to A to $10,000 ($100 per share times 100 shares sold). No further gain is recognized on the transaction because A’s adjusted basis in the stock, plus the ordinary income recognized on the sale, exceeds the amount realized, see §306(a)(1)(C), and loss cannot be recognized under §306(a). In effect, the remaining $1,000 of amount realized is offset against A's basis in the preferred stock, with A's unoffset basis in the preferred stock ($3,000) flowing back into A’s common stock. See Regs. §1.306-1(b)(2)(ex 3). Accordingly, the subsequent disposition by A of his common stock to Q for $40,000 will produce a taxable gain of $31,000 (amount realized equals $40,000; adjusted basis equals $9,000).

It might be the case that the sales by A of the preferred and common stock are two parts of the same transaction. If so, the sale of the preferred stock could escape taxation under §306 by virtue of §306(b)(4)(B), thereby giving A exchange treatment on both. Note, though, that application of §306(b)(4) requires more than a prior or simultaneous disposition of the common; it also requires a showing that the disposition of the preferred stock was not in pursuance of tax avoidance.

6-3b. A redemption of §306 stock is taxed under §301 as a distribution pursuant to §306(a)(2); the safe harbors of §302(b) are not available! Accordingly, the earnings and profits of the corporation in the year of redemption are relevant. Since the amount distributed to A is $11,000, and there are earnings and profits of $50,000, A will have ordinary income of $11,000 on the redemption under §30l(c)(1). A's basis in the preferred stock flows back into his common stock, see Regs. § 1.306-1(b)(2)(ex. 3), restoring the common stock basis to $10,000. X Corp. will reduce earnings and profits by $11,000. §312(a).

6-3c. Implicated by this problem is §306(b)(4)(B). It is unclear from the language of that section whether a complete disposition of the common is required. See the discussion of this issue in *Fireoved* at page 237 of the text. A, in this problem, has a stronger argument than did the taxpayer in *Fireoved* because the redemption of half of his common leaves B in control of the corporation. If §306(b)(4) applies, then the redemption will be subject to the rules of §302, and redemption of the preferred should qualify for exchange treatment under §302(b)(1) while redemption of the common will qualify under §302(b)(2).

If §306(b)(4) does not apply, we know that A's basis in the preferred stock flows into his common stock. Should some of it flow into the common stock being redeemed at the same time, effectively treating the preferred stock as if it were redeemed prior to the common? Since it makes sense to tax the simultaneous redemption of preferred and common stock no more harshly than a redemption of the preferred stock prior to the common, presumably the preferred stock basis will flow into both the redeemed and non-redeemed common stock.

6-3d. Had there been no earnings and profits for 2010, the preferred stock would not have been tainted under §306. See §306(c)(2). The existence of $1 of earnings and profits, on the other hand, would support a §306 taint, and while disposition of §306 stock *other than* by redemption is influenced by the amount of earnings and profits of the corporation at the time of issuance of the tainted stock, see §306(a)(1)(A), disposition by redemption is not, see §306(a)(2).