

My outline for Corporate Tax

- 1) Birth and formation of corporations: when people put money in exchange for control
 - a) § 351¹ allows 1) **one or more person** to 2) put **property** (not services) in 3) **solely for stock** and 4) **be in control**

- i) definitions
 - (1) one or more **persons** (for purposes of § 351)

- (a) can be corporations
- (2) **property** (for purposes of § 351)
- (a) If more than 20% of any class of stock is issued to service

provider, the entire transaction will not qualify under § 351 because *transferors of property do not have immediate control after the exchange*

- (b) stock issued for services (past or present) are not included 351(d)(1); 1.351-1(a)(1)(i)
 - (i) but if a service creates an intangible right it may be treated as property
 - (ii) one who transfers **only** services will not be included in the test for control
 - (iii) cannot be for services, however, the services allows a mixed transfers of property and services to count, so long as the amount of serves is not under the de minimis amount of 10%

- (c) debt assumption and issues

- (i) **issue**: When a corporation exchanges its stock for a note, future payments are recognized, but current principal paid is not -- check this
- (ii) **Cancellation**: of corporate indebtedness: does not fall under § 351, and is recognized because of § 61(a)(12) (income includes Income from discharge of indebtedness)
- (iii) **Assumption**: If the corporation assumes liability in exchange for stock: not gain to shareholder, but treated as boot for purposes of determining basis in the stock (Sec. 357(A)-(C))

- 1. Defining assumption
 - a. if a shareholder remains personally liable, he must still recognize the gain. *Owen*
- 2. **Encumbrances** can be reduced by the transfer of a note from by the taxpayer to the corporation, and the corporation gets a basis in the note equal to its, fmv, and the negative basis in the property transferred is reduced
 - a. 9th cir *Peracchi*: must look to subjective character of loan, to see if it is true, and the greater the risk of the corporation going bankrupt, and the shareholder losing control over it, the greater the chance that it should

- 1) § 351: formation
 - a) non-recognition of property, stock, assumed liabilities, and boot
 - b) contributions of capital
- 2) debt v. equity characteristics
- 3) non-liquidating distributions
 - a) dividend v. return of capital or basis
 - b) redemptions v. partial liquidation
 - i) constructive ownership which makes a redemption not a redemption
 - ii) brother-sister and parent subsidiary acquisitions
- 4) stock distributions and tainted 306 stock
- 5) complete liquidations

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¹ 351 No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

count ("if bankruptcy is so remote that there is no realistic possible it will ever occur, we can ignore the potential economic effect of the note, and treat it merely as an unenforceable promise to contribute capital in the future)

- i. if bankruptcy not a real risk, can't use note
 - b. Lessinger (2d cir): taxpayer who transfers an enforceable note has a basis equal to the face value. Logic: 100% shareholder transferred note to his corporation, corporation need not issue additional shares for 351 to apply, corporation was deemed to have issued additional shares, corporation therefore assumes the liabilities provided that the **note is genuine, corporation recognizes gain when the shareholder repays, therefore this must be the shareholder's basis**): a note transferred by the corporation does count to reduce the basis because
 - c. Alderman (Tax court): service is correct. These notes are not for real, and the taxpayer cannot avoid the bite of 357(c)
3. Exception for Liabilities that are assumed, but have not been taken into account by the transferor for tax purposes (e. g. because he is a cash basis payer) are not considered to be gain § 357(c)(3)
 4. Contingent liabilities (such as brownfields Rev. Rule 95-74) are not taken into account either 358(d)(2)

(3) Transfers

- (a) non-exclusive rights is not a transfer
- (b) must transfer all rights in the property (not a limited license) – this will be considered royalty income
- (c) Du Pont: *perpetual nonexclusive license* will satisfy test

(4) stock v. boot (for purposes of § 351)

- (a) boot: solely in exchange for **stock** of the transferee corporation (b)if a someone (transferor) who gets something other than stock, he must recapture any depreciation in that boot. 351(a)
- (b) transferor immediately recognizes any value of boot received § 351(b)(2)
 - (i) even if a transferor receives boot, he may not recognize a loss § 351(b)(2)
 1. but the shareholders basis in the stock will be increased
 2. it seems you can't recognize more than the basis in the property
 - (ii) realized gain on a transferred asset is recognized to the extent of the boot allocable to the asset. 351(b)
 - (iii) However, the boot allocated to a loss asset will not cause recognition of gain or loss *Rev. Rul 68.55*

(5) control (for purposes of § 351)

- (a) two criteria that must both be satisfied as per Rev. Rul 59-259
 - (i) own at least 80% of the total combined voting power of all classes of stock entitled to vote 368(c)²

² 368(c) (c) Control defined.--For purposes of part I (other than section 304), part II, this part, and part V, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

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1. voting stock is defined as stock that can vote for the directors at the time of issuance or at the relevant testing date
- (ii) and 80% of each nonvoting class of stock 368(c)
 1. can issue new classes of stock
- (iii) To determine whether the group is in control of the corporation, but look at the entire group of non- *de minimis* parties
 1. IRS defines *de minimis* in rev procedures as less than 10% of the stock already owned or in excess of 10% -- this prevents someone from asserting the non-recognition rule based on a small contribution from someone whose additional contribution would give them the required amount of control³
- (b) must be ownership (equity) interest in a corporation 1.351-1(a)(1)
 - (i) old definition was “securities”
 - (ii) non-qualified preferred stock is preferred stock is 1) limited in dividends 2) has other debt-like features 3) features that give the corporation or the holder the right to dispose of stock back to the corporation within a set amount of time (this is a feature of debt)
 - (iii) Can’t be warrants or stock rights⁴ – and “debt-like stock” is treated as boot
 - (iv) Note: taxpayers can recognize a loss if only nonqualified preferred stock is received in an exchange
- (c) note: it doesn't matter that some transferors receive voting stock, while others receive nonvoting stock
- (d) one who transfers only services may not be included in the test for control 351(d)(1) 1.351-1(a)(1)(i), and the service-providing shareholder recognizes ordinary § 61 income
 - (i) timing of gain on stock received for services
 1. if the stock is subject to a risk of forfeiture or is simply not transferrable: at the time any restrictions on the dispositions of the stock lapse, the service provider is taxed § 83
 - a. no additional income is recognized when the restriction lapse – only when any stock is disposed of 1.83-2(a)(1) (check this)

³ Rev. Proc. 77-37 When a person transfers property to a corporation in exchange for stock or securities of such corporation and the primary purpose of the transfer is to qualify under section 351 of the Code the exchanges of property by other persons transferring property, the property transferred will not be considered to be of relatively small value, within the meaning of section 1.351- 1(a)(1)(ii) of the regulations, if the fair market value of the property transferred is equal to, or in excess of, 10 percent of the fair market value of the stock and securities already owned (or to be received for services) by such person.

⁴ 351(g)(2)(A) In general.--The term "nonqualified preferred stock" means preferred stock if—

- (i) the holder of such stock has the right to **require** the issuer or a related person to redeem or purchase the stock,
- (ii) the issuer or a related person is **required to redeem** or purchase such stock,
- (iii) the issuer or a related person has the **right to redeem** or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, **or**
- (iv) the **dividend rate** on such stock **varies** in whole or in part (directly or indirectly) **with reference** to interest rates, commodity prices, or other similar indices.

- 2. election by service provider but, a service provider can elect under § 83(b) to be taxed on the fmv of the stock at the time of the transfer, and no additional income is recognized when the restriction lapses 1.83-2(a)(1) (check this)
- (ii) service providers basis in stock received for services: amount paid + amount included in come. 1.83-4(b)(1)
 - 1. forfeitures can be deducted as a long term capital loss of the cash paid for them
- (iii) a corporation that issues stock in exchange for services can deduct whatever the amount of ordinary income that was taxable to the service provider § 162(a) – unless there the services provided are required to be amortized or capitalized
- (b) mixed transfers of services and property: do, in general count** for the 80% control requirement
 - (i) if the property represents more than 10% of the value of the transfer, it will count in the test
 - (ii) if the property represents less than 10% of the value of the transfer (diminimus), it will not count in the test
 - (e) debt does not count (it used to, however)
- (6) **Simultaneousness**: only have to be part of a pre-defined agreement⁵ (should be legally binding)
- (7) **immediately** after the exchange
 - (c) the test for control is done immediately after the exchange, but it does no matter how long the stock is held for
 - (i) only if there is a binding agreement to transfer shares away and divest someone of control will someone be deemed not to be in control *Intermountain Lumber*
 - (d) there is no requirement for simultaneous transfer, so long as the rights of the parties were "previously defined" and it followed some order 1.351-1(a)(1)
 - (e) **but** a required disposition of stock pursuant to a binding agreement means that there was no control to start with, and that stock is not included in the 80% test. *International Lumber*
 - (f) a later gift of the stock will not change the character of the transaction (because gifts are not binding) *Wilgard realty*
 - (g) corporations that transfer stock can all or part of their stock to their shareholders 351(c)
 - (h) there are three versions of the *step transaction doctrine*⁶ that can be applied
 - (i) end result test: IRS and the courts can look @ the end result and recharacterize that transaction to reach that result
 - (ii) mutual interdependence test: two more transactions will be stepped together

⁵ 1.315-1(a) ...The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure...

⁶ A business transaction often has no clearly defined beginning or end, but it may be necessary in practice to divide it, usually chronologically, into segments for tax purposes. If the segment is too thin, however, the tax results may be unfair to the taxpayer or the government or both. In viewing a dynamic whole, the courts often say that an integrated transaction must not be broken into independent steps or conversely that the separate steps must be taken together in attaching tax consequences. The so-called step transaction doctrine is encountered most often in the taxation of corporations and shareholders, but its scope is much broader.

- (iii) actually has to be a binding commitment b3 u enter into the first step, if you want to piece the two transactions together
- ii) results of a § 351 exchange
 - (1) Basis
 - (a) In general, the corporation takes the cost basis of the property a.k.a., its basis is the cost basis of the stock that it is giving up⁷
 - (i) To Determine character of 357(c) "gain" (when new basis is less than zero), allocate gain amount the transferred pro rata assets among the fair market value
 - (b) Tax free transfers: if the exchange were tax free (to the transferor) then the corporation takes with the original basis
 - (c) Shareholder receives a basis that is reduced by the value of the indebtedness assumed
 - (i) Must allocate the character of the gain to the transferred assets (based on their gross value) 1.357-2
 - (ii) No negative bases: If the assumed liabilities are greater than the shareholder's basis, then the shareholder's basis in the stock is zero, because they really have debt relief.
 - 1. **357(C) catchall** If the new basis is less than zero (liabilities greater than original basis of stock), however, **357(c)** applies, and the difference between the negative is treated as currently realized boot
 - a. If § 357(c) applies, the corporation's (transferee's) basis is **always zero**
 - b. To Determine character of § 357(c) "gain" (when new basis is less than zero), allocate gain amount the transferred pro ratta assets among the fair market value
 - 2. § **357(c)** does not apply if the transferor has not taken into account these liabilities for tax purposes. Rev. Rul 95-74 (property subject to liabilities that have not been taken into account, do not increase their basis subject to § 357(c))
 - 3. because values of assets are aggregated, bases can be increased to zero by transferring cash (since bases are aggregated)
 - a. In the case of multiple assets transferred to the corporation that are subject to liability, (cross-collateralized) , the **non-recourse liability** will be reduced by the lesser of "the amount of such liability which an owner of other assets no transferred to the transferee and also subject to the liability has agreed with the transfer to, and is expected to, satisfy"
 - b. e. g. must be reduced by whatever portion was not transferred
 - 4. criticisms of 357(c)
 - a. bit self executing – only comes up in audit
 - b. overly broad – it is all or nothing
 - (d) If the corporation **assumes** liability in exchange for stock: not gain to shareholder, but treated as boot for purposes of determining basis in the stock (§ 357(A)-(C))
 - (iv) Assumption of debt is not treated as boot, but is added to basis of transferor

⁷ 1032(b) 362(a)(2)	For basis of property acquired by a corporation in certain exchanges for its stock, see § 362 as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.
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1. If the assumed liabilities are greater than the shareholder's basis, then the shareholder's basis in the stock is zero, because they really have debt relief.
 - (v) Shareholder receives a basis in the stock that is reduced by the value of the indebtedness assumed
 - Must allocate the character of the gain to the transferred assets (based on their gross value) 1.357-2
 - (a) tax avoidance or not a bona fide corporation business purpose § 357(b)⁸ in this case, all of the relieved liabilities are treated as boot. Reg. 1.357-1(c)
 - (i) Taxpayer has burden of proving by preponderance that this is so. 357(b)(2)
 - (ii) Examples might include deliberately encumbering property shortly before a transfer
 - (3) From the transferee's perspective: §§ 351 and 1032 prevent the shareholder from being forced to recognize ordinary income
 - iii) Strategy: ways to avoid § 351, and recognize gain at transfer
 - (1) Transfer property not for stock
 - (2) Avoid control requirement (e.g. transfer for services)
 - (3) Binding contract to reduce control after the transfer
 - (a) Transfer things where they could be a radically different character
 - b) transactions by the corporation of its own stock § 1032: no recognized gain to corporation when selling (or buying its own shares), since it is merely a change in form. § 1032 allows corporations to traffic in their own stock in exchange for property or services (for these purposes the IRS deems transactions in services to be transactions in property)
 - ii) but 362: corporation's **basis** in property transferred is preserved. So-called *transferred or carryover basis*
 - (1) a corporation that receives boot, will have a basis of the value of the property received plus anything that the transferor realized 362(a)
 - (2) if there is an installment not resulting in a deferred gain to the transferor, the corporation may only increase its basis when it pays that note (e. g. when the gain is recognized). Proposed Regulation 1.453-1(f)(3)(ii).
 - (3) If there are several assets, there is no authority on how the basis should be attributed
 - (a) However, it probably should be the transferor's basis, increased by any gain recognized
 - iii) holding period:
 - (1) 1231 or capital assets: carried over holding period
 - (2) everything else holding periods begin on date of exchange
 - iv) a corporation that issues stock in exchange for services can deduct whatever the amount of ordinary income that was taxable to the service provider § 162(a) – unless there the services provided are required to be amortized or capitalized
 - v) steps
 - (1) calculate amount transferor recognizes

⁸ 351(b) RECEIPT OF PROPERTY.--

If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then--

351(b)(1) gain (if any) to such recipient shall be recognized, but not in excess of--

351(b)(1)(A) the amount of money received, plus

351(b)(1)(B) the fair market value of such other property received; and

351(b)(2) no loss to such recipient shall be recognized.

- (a) current boot
- (b) deferred installment not boot
- (2) calculate transferor's basis in stock received
 - (a) basis in property transferred
 - (b) minus value of boot received
 - (c) plus total value which was realized by transferor (even if delayed recognition)
- (3) initial basis in property received by corporation is
 - (a) transferor's basis
 - (b) plus gain recognized by transferor in year one
- (4) basis increases when note is paid off
 - (a) if they sell the property before the note is paid off must recognize gain, however when the note is paid off, it can deduct that remaining basis as a capital loss Proposed Regulation 1.453-1(f)(3)(iii)
- c) shareholders don't have to so easy. They will only be able to will only be able to avoid recognition of gain if they assume control of the corporation. This is considered to be a **change of form**⁹ of their wealth, rather than an actual transaction resulting in gain or loss to any of the parties. Afterwards the parties must actually be in control.¹⁰
 - i) Can't be sham transaction
 - (1) Must be actual purchase, not as a disguised transaction between two parties¹¹
 - ii) Elements of the § 351 exchange that will avoid recognition
 - (5) one or more **persons** (including individuals, corporations, partnerships)
 - (a) the people getting the stock need not get it in proportion to what they contributed
 - (i) they are treated as having received the stock in proportion to the value of the transferred property, and then having transferred the property amongst themselves. 1.351-1(b)(1),(b)(2), ex. 1
 - 1. e. g. first treated as a sale, then the imbalances are treated as gifts resulting and is taxed on the fmv of the stock received, and takes a later basis of that fmv. The ones transferors who are treated as giving up the stock are treated as realizing a gain in satisfying an obligation
 - (b) Transfers to "investment companies" do not count. 351(e)
 - iii) Results of an actual exchange
 - (1) No gain or loss recognized to the person or the shareholder under 1031, and 1032
 - (2) Shareholders take the stock received in exchange for a carryover basis, so he has the same basis as the transferred assets (358¹²'s deferred gain) this is called *exchange basis property*¹³

⁹

¹⁰ 351(a) General rule.--No gain or loss shall be recognized if property is transferred to a corporation by **one or more** persons solely in **exchange for stock** in such corporation and **immediately** after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

¹¹ Intermountain Lumber ... Accordingly, if the transferor sells his stock as part of the same transaction, the transaction is taxable because there has been more than a mere change in form.

¹² 358(a)(1) Nonrecognition property.--The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged

(3) Calculation of holding period

(a) tacking:

(i) capital assets: holding period for stock received for stock in exchange for stock or a § 1231 (check this) asset is the holding period of the transferred property **plus** the holding period of the stock § 1223(1).

(ii) Ordinary income assets: begins on **immediately** date of exchange

(iii) Capital and ordinary assets: if property is transferred for a combination of capital and ordinary assets, each share takes a **split** holding period, in proportion to the fmV of the transferred assets. Rev. Rule 85-164

1. However, dividing up holding periods upon shares (e.g. if one share of stock was later sold) can be quite difficult, as individual shares of stock now have multiple holding periods

(b) Character of gain received is determined by the character of the assets transferred

(c) Installment sales as a means of realization

(i) § 453: gain can be recognized as the note is paid off (though there is a provision to opt out)

(ii) all payments of interest on such a note are gain

(d) determining when gain will be recognized under 1.453-1(c)(f)(1)(iii)

(i) boot: transferor recognizes immediately on receipt on boot

(ii) cash: transferor recognizes immediately on receipt on boot

(iii) Installment sales as a means of realization

1. § 453: gain can be recognized as the note is paid off (though there is a provision to opt out)

2. all payments of interest on such a note are gain

3. in proposed regulations, a transferor can immediately increase the basis in any non-recognition property (e.g. stock) by the transferor's total potential recognized gain, but they delay the corporations corresponding § 362(a) basis increase in its assets until the transferor actually recognizes gain on the installment method proposed Reg. § 1.453-1(f)(3)(ii)

a. transferee realizes gain

i. proposed regs divided it into a 351(a) non- recognition transaction with respect to the stock receive

ii. and a installment sale with regard to the boot

iii. basis is allocated first to the boot received

iv. if the transferor's basis exceeds the fair market value of the non-recognition property received the excess basis is allocated to the installment portion of he transaction (p. 71 of book)

v. the "selling price" (fair market value of boot plus face value of installment obligation) is then allocated to the installment portion of the transaction, based on the ratio of (difference between fair market value and selling price/selling price)

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7701(a)(44)

Exchanged basis property.--The term "exchanged basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.

- b. corporation's basis is the same as the transferor's basis increased by the gain recognized only if, the gain is actually recognized.
- (4) Corporation has a carryover basis in the property received. This creates double taxation, but it could have been avoided if the transferor had sold his property and used it to buy the original stock¹⁴
- (5) but 358: shareholder's **basis** in property transferred is preserved
 - (a) stock received will have the same basis as the stock received immediately prior to the exchange § 358(a)(1) -- this is *exchanged* or *substituted* basis
 - (b) if a transferor receives more than one class the aggregated basis is **allocated** among all classes of stock received in proportion to the fmv of each class. Reg. 1.358-2(a)(2)
 - (c) example equation to determine shareholder's basis in property
 - (i) transferor's basis in property transferred equals (this applies even if there is an installment sale 1.453-1(f)(3)(ii)
 - 1. basis in stock equal basis in transferred property
 - 2. minus amount of cash
 - 3. minus amount of boot (debt, assumption of liability and other property)
 - a. usually fmv 358(a)(2)
 - b. but if debt, it is face value minus the amount of income that will be taxable if the obligation is satisfied in full 453B(b)
 - 4. plus gain immediately recognized by transferor
 - (ii) allocate basis among differing classes of stock received 1.358-2(a)(2)
- (6) recognition of boot
 - (a) However, the boot allocated to a loss asset will not cause recognition of gain or loss. Instead, the IRS says one must look at the property bit by bit and allocate the property on a pro rata basis based on these assets *Rev. Rul 68-55*.¹⁵ – e.g. boot must be allocated to other assets, and their basis can be increased
 - (b) Steps for determining allocation of basis when boot is received
 - (i) Determine proportion of fair market value of assets transferred

¹⁴ Boot (property other than stock)

Gain boot	Shareholder Property. Gain realized to the extent of fair market value of boot. If several assets are transferred, the value of the boot is allocated among the transferred assets and realized gain is recognized to the extent of the boot allocable to that asset/ Stock received: So, it is transferor's basis in the property minus amount of cash plus gain recognized.	Corporation If the corporation recognizes gain because of boot, the corporation's basis is the transferor's basis plus any gain recognized. If transferor recognizes gain when assets are transferred for a combination of stock and boot the there is a basis increase which is to be allocated among the assets.
	Loss boot	No loss may be recognized. § 351(b)(2)

¹⁵ In determining the amount of gain recognized under section 351(b) of the Internal Revenue Code of 1954 where several assets were transferred to a corporation, each asset must be considered transferred separately in exchange for a portion of each category of consideration received. The fair market value of each category of consideration received is separately allocated to the transferred assets in proportion to the relative fair market values of the transferred assets. Where as a result of such allocation there is a realized loss with respect to any asset, such loss is not recognized under section 351(b)(2) of the Code.

- (ii) Allocate boot received between those assets in proportion to the value of the assets transferred
- (iii) Each of these is the amount of *gain* (of whatever type of asset) – there cannot be a loss realized
 1. only a value up to the fair market value of boot received must be immediately recognized § 351(b)
 2. obviously, subtract the basis in the property transferred from the amount of gain recognized
- (7) installment obligations (such as notes transferred to the taxpayer)
 - (a) divide stock into 1) boot immediately received and 2) taxable installment instrument sale
 - (i) basis of transferred property is allocated to the fair market value of extent of **stock received**
 - (ii) § 453 provides for installment sale reporting, the shareholder recognizes the gain as the installments come due (regs., not statutes) Proposed regulations 1.453-1(f)(1),(3)(ii). Use the gross profit percentage to determine how much of the remaining value must be allocated
 - (b) steps
 - (i) determine realized gain: (value of property received minus fmv of what was given up)
 - (ii) limit recognized gain to whatever the **fmv of whatever was transferred + its basis**
 1. (e. g. can't recognize more than the total amount of what was given up)
 - (iii) if depreciable property is transferred everything must be realized up front
 - (iv) allocate basis in property given up (minus boot) to the first property received
 - (v) allocate "excess basis" (whatever is left) to the value of the second property received (could be total value of monies to be received from a note) on the basis of gross profit percentage
 1. gross profit is the total value of the note minus the basis (or money paid for it)
 2. gross profit percentage is the percentage of the profit percentage
 3. in the first installment (or cash received) recognition is $gpp * \text{cash (or other boot) received}$
 - (c) in other installments recognition is **$gpp * \text{when other boot is received}$**
- d) Corporations can also buy assets, or somehow issue debt
- 2) Contributions to capital
 - a) Shareholder may increase their basis in other shares
 - b) Corporation take zero basis but is not taxed
 - i) If cash received, must reduce other bases
- 3) Taxation of debt v. equity (differentiation between the two will not be on the test, but the criteria is found in Fin Hay)
 - a) Equity
 - i) Dividends are includible in shareholders income but are not deductible to corporation
 - ii) No gain or loss when corps repurchase stock
 - iii) Note: corps that receive dividends from other corporations pay tax at a lower rate

- iv) Bad stock¹⁶: [165\(g\)](#) (note: no distinction between business and non-business)
 - (1) Can take a deduction when the stock becomes “worthless” or when sold
 - (a) Limitations
 - (i) Can only take worthless stock deduction once
 - (ii) Must take in the year that it is worthless (alternative is to sell it)
 - (2) Regulations define “worthless” but most people would rather just sell the stock to realize the loss and not take the litigation risk¹⁷
 - (a) This is a question of fact where the burden is on the taxpayer
 - (b) A decline in market value is not a loss
 - (3) Timing
 - (a) Short term less than a year
 - (b) Long term more than a year
 - (c) But if you are a deduction under 165(g)(1), taxpayer is deemed to have disposed the stock on the last day of the taxable year
- v) Special provision for small business: § [1244](#) for individuals: can treat certain losses from sale or exchange of stock as ordinary (as opposed to capital) loss
 - (1) Must be an individual (or partnership)
 - (2) Monetary limits
 - (a) 50,000 for singles
 - (b) 100,000 for married couples filing jointly
 - (3) criteria
 - (a) must be domestic corporation
 - (b) was a “small business corporation” is defined as if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed \$1,000,000.
 - (c) stock was issued by such corporation for money or other property (not stock)
 - (i) Property. For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock
 - (d) corporation must be engaged in active business : in the past 5 years, the corporation derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities
 - (e) must receive stock directly from corporation

¹⁶ (1) General rule.--If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

...

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

¹⁷ 1.165-4(a): Deduction disallowed. No deduction shall be allowed under section 165(a) solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or to other similar cause. **A mere shrinkage in the value of stock owned by the taxpayer, even though extensive, does not give rise to a deduction under section 165(a) if the stock has any recognizable value** on the date claimed as the date of loss. No loss for a decline in the value of stock owned by the taxpayer shall be allowed as a deduction under section 165(a) except insofar as the loss is recognized under §1.1002-1 upon the sale or exchange of the stock and except as otherwise provided in §1.165-5 with respect to stock which becomes worthless during the taxable year.

vi) note: sale of 306-tainted stock will result in realization of ordinary income

b) debt

i) In repayment, creditors don't recognize any gain or loss

ii) Premiums for early repayment of debt are deductible

iii) Bad debt: § 166¹⁸ – depends on whether business or personal debt, but taxpayer is entitled to a deduction when a debt becomes worthless

(1) Defining worthless

(a) Worthlessness is a question of fact, and no particular legal action is required.

(b) Bankruptcy is an indicia of worthlessness

(c) Debts can become worthless before they come due

(2) Timing:: Must be taken in the year that the debt becomes worthless, unless the debt is sold

(3) character

(a) Business debt: ordinary losses

(i) Can be written off when they become partially worthless, but must “charge off” under GAAP

(ii) Any time a corporation lends money, and the debt goes bad, it is a business bad debt¹⁹

(b) Personal debt (non-business): capital losses

(i) Can only be written off when they become wholly worthless

4) non-liquidating distributions (treated as sales, unless they are dividends): a distribution must be with respect to stock to be treated as a dividend

a) definitions

i) a distribution is a dividend to the extent that it is made out the “earnings and profits” for the current taxable year, and if they are insufficient to the accumulated earnings and profits since 1913 regulations say that a distribution to a shareholder is only in his **capacity as a**

¹⁸ (a) General rule.--

(1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.--When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of deduction.--For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

...

(c) Nonbusiness debts.--

(1) General rule.--In the case of a taxpayer [non-corporation]

(d) (A) subsection (a) shall not apply to any nonbusiness debt; and (B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

...

¹⁹ 166(d)(2) Nonbusiness debt defined. For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

shareholder²⁰ -- because each shareholder has a different bases, each shareholder is individually analyzed

- (1) elements
 - (a) distribution
 - (b) of property (as defined in section 317(a))
 - (c) money or other tangible property
 - (i) does not include stock or rights to acquire stock
 - (ii) made by a corporation
 - (c) to a shareholder
 - (d) in his capacity as a shareholder
- (2) amount of distribution is the amount of cash received by shareholder plus the fair market value of any property received
- (3) does not apply to distributions of rights to stock or distributions of stock (stock dividends)
- (4) accounting rules
 - (a) each shareholder individually analyzed
 - (b) anti-evasion rules: a series of distributions will be treated as one
- (5) defining earnings and profits: do not determine to the end of the taxable year!
 - (a) start with taxable income
 - (b) add back in excludible items
 - (i) tax exempt municipal bond interest
 - (ii) life insurance proceeds
 - (iii) federal tax refunds 1.312-6(b)
 - (iv) do not add in: contributions to capital and realized gains that are not recognized for tax purposes
 - (c) add in tax-deductible items that do not represent actual “economic outlay”
 - (i) dividends received deduction (note: there is no deduction for
 - (ii) NOL deductions (since it is taken care of in year incurred)
 - (iii) Capital losses
 - (d) subtract non-deductible items
 - (i) subtract federal income taxes
 - (ii) expenses related to tax-exempt income
 - (iii) losses between related taxpayers
 - (iv) charitable contributions in excess of limitations
 - (e) timing adjustments: to override timing rules in rest of code
 - (i) add back in depreciation
 - (ii) change basis in property sold so as not to reflect depreciation
 - (iii) § 312(k)(3)(B): corporation must amortize expenses that were “expensed” ratably
 - (iv) installment sale: realized gains that were deferred under installment sales have to be added back in for the year of the sale 312(n)(5)
 - (v) anything reported on LIFO, must be reported under FIFO 312(h)(4)
 - (vi) account method (cash v. accrual) remains the same
- (d) steps examples from Rev. Rule 74-164²¹

²⁰ 1.301-1c

²¹

Distribution	earnings	Results Source of dividends
--------------	----------	--------------------------------

- (i) determine current earnings and profits, as of the end of the taxable year w/o reducing it by the other distributions made during the year 1.316-2(a)
 - (ii) where a corporation has common and preferred stock, distributions to preferred stock holders absorb earnings and profits before distributions to holders of common stock
 - (iii) when there are insufficient earnings and profits, determined as of the end of the year, the current earnings must be pro-rated amount all of the distributions 1.316-2(b)(c), example
 - (iv) use this formula: $\text{deduction from current e\&p} = \text{amount of each distribution} * \frac{\text{current e \& p}}{\text{total current distributions}}$
 - (v) accumulated earnings are allocated chronologically to each distribution
 - (vi) if there is a current loss, but accumulated earnings:
 1. in usual case, corp. cannot prove at what point the loss came from: must determine the amount of accumulated e&p at the time of the distribution (gets reduced at every further distribution)
 - (vii) if the corp. can name the point that the loss occurred, then the earnings and profits will be applied to that date
- (4) two categories
- (a) earnings and profits from the current year
 - (b) earnings and profits since 1913
- iv) other ways corporations can give money to shareholders **that are not dividends**
- (1) employ them (deductible as compensation)
 - (2) Redemption of stock. For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock. Redemptions could be tainted
- c) treatment of dividends (broken into three pieces) by § 301(c) (must be analyzed in order)
- i) portion will be treated as a dividend that will be included in gross income as ordinary income (taxable)

Distributed 7/1	Accumulated	As of distribution	Current year	current	accumulated
15,000	40,000	(50,000)	5,000	5,000 (all 316 dividend)	10,000 (all 316 dividend)
15,000	-60,000	75,000	5,000	5,000 is dividend	
15,000	-60,000	75,000	-5,000	15,000 is dividend	
15,000	-60,000	75,000	-55,000	12,500 is dividend because the 75,000 is pro-rated to 1/2 of the year	

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- ii) portion will be treated as a return of basis (not taxable, but will result in a reduction of basis) (e.g. the portions that are not accumulated or in current taxable year) (non-taxable)
 - (1) where there are insufficient current earnings and profits available to cover cash distributions during the year, earnings and profits must be allocated to the distribution in order to determine dividend status under the following rules
 - (2) must prorate earnings and profits among distributions using this formula: Current earnings and profits allocated to each distribution = amount of distribution * (total current earnings and profits / total distributions) Reg. 1.316-2(b),(c) Example**
 - (3) but, accumulated earnings are allocated chronologically to distributions (first come, first served)
 - (a) if the corporation has a current loss but has accumulated earnings and profits from prior years, it will be necessary to determine the amount of accumulated earnings and profits available on the date of distribution – unless the loss can be earmarked to a particular period, the current deficit is prorated to the date of the distribution Reg. 1.317-2(b)

Current earnings and profits	> distribution	Each distribution is a dividend out of current earnings and profits. 1.316-2(b)
Current earnings and profits	< distribution	Portion of each distribution treated as coming from current e&p
Accumulated e&p and current deficit	=	$\frac{\text{amount of each distribution} * \text{current e\&p} / \text{total current distributions}}{\text{accumulated EP as of the beginning the year is reduced by portion of the current deficit allocable to the period prior to distribution. Current EP is then po-rated on a daily basis to the date of distribution. Rev 1.316-2(b)}$
<p>Note: if the corporation can trace the deficit to a particular time of year, they are welcome to try.</p>		

iii) shareholders basis has been applied against them or reduced to zero, and shall be treated as gain from the sale or stock or cap. gain. (gain from sale)

iv) **dividend received deduction:** when corporations receive a dividend they are eligible for a deduction

(1) general limits

- (a) 70%: general rule
- (b) 80%: (from 242(c)): where the parent corporation holds more than 20%
- (c) 100%: where they are affiliated under 243(a)(3)
 - (i) a 100% dividend will never be treated as extraordinary dividends 1059(e)(3)(C)(i)

(2) options and DRD: Immediate gain if a redemption is treated as a dividend when the

Steps to DRD

- 1) Determine whether the DRD to a corporation is 70, 80, 100% of the dividend to the corporation
- 2) If it is 70, 80, it is limited to that amount, or 70 or 80% of the corporations taxable income
- 3) But, if the corporation has a net operating loss, there is no step #2 limit (e.g. when the full DRD would produce a loss, the limit doesn't kick in)¹

- nontaxed portion of the dividend exceeds the basis of the shares surrendered if the redemption is treated as a dividend because of the holding of options that are really constructive ownership § 318
- (3) qualitative limits (no limits if corporation has NOL)
- (a) anti-short-term holding provisions: no deduction if (anti-short term holdings provisions)
 - (i) common stock: the holding period is under 45 days... during the 90 day ex-dividend period (the time which one is entitled to receive a dividend)
 - (ii) preferred stock: 90 days during the beginning on the day which is 180 day before the ex-dividend date
 - (b) tolling of restrictions: period is tolled if there is a call or put option on the stock: purpose is to force the shareholders to take genuine market risk b/c preferred stock is more stable
 - (i) no deduction if something is *debt-financed portfolio stock* owned during a “*base period*” under 246A: i.e. deduction only to the extent that one gets an interest in the stock
 - (ii) defining debt-financed portfolio
 - 1. debt financed: any indebtedness attributed directly to the investment in the portfolio stock
 - 2. either purchased w/ borrowed funds or traceable to the borrowed funds
 - (iii) portfolio stock: any stock of the corporation unless the corporate shareholder owns either 50% of voting power and value –or- at least 20% of the voting power and value and five or fewer corporate shareholder own at least 50% of the voting power and value § 246A(d)(3)(A)
 - (iv) base period: calculated debt over average date over each day during the period
 - (c) rules
 - (i) no deduction if stock purchase is entirely debt financed (**DRD=DRD*(100-average indebtedness%)**)
 - 1. point of this is to keep a corp from getting DRD and interest deduction
 - (ii) if it is partially debt-financed, the deduction must be reduced by that portion 246A(e)²²
- (4) extraordinary dividend limitations (dividend stripping of extraordinary dividends (1059): if a corporate shareholder holds a share of stock for less than two years, the corporation must reduce its basis in the stock of the dividend below (but not below zero) by the amount of the dividend received deduction (1059(b)))
- (a) an extraordinary dividend is
 - (i) preferred: 5% of adjusted basis
 - (ii) non-preferred: 10% of adjusted basis
 - (iii) or if it is non-pro-rata, or part of a partial liquidation 302(e) (see later)
 - (iv) one which is not a *qualified preferred dividend*
 - 1. a *qualified preferred dividend* is not treated as an extraordinary dividend if the dividends do not exceed a rate of 15% of the lesser of the shareholders adjusted

²² 256A(e): Under regulations prescribed by the Secretary, any reduction under this section in the amount allowable as a deduction under [section 243](#), 244, or 245 with respect to any dividend shall not exceed the amount of any interest deduction (including any deductible short sale expense) allocable to such dividend.

basis or the liquidation preference of the stock 2) and the stock is owned by the shareholder for over 5 years

- (b) all dividends within 85 days are treated as one dividend
- ii) If the nontaxed amount exceeds a portion of the adjusted basis, any excess is treated as gain from the sale of stock
- b) **distributions that don't qualify as dividends because of statutory exclusions:** Things that don't qualify as a dividend because of the Safe harbors in § 302 (which defines when one is actually giving up stock and control in a corporation) – and if none of the § 301 tests apply, § 302(d) says that it must be treated as a 301 distribution
 - i) (or) Not “essentially the same” as a dividend (defined by common law) (not "essentially the same", substantially disproportionate, complete termination, or partial liquidation)
 - ii) (or) “substantially disproportionate”:
 - (1) Immediately after the redemption, shareholder must own less than 50% of the total combined voting power of the stock (attribution rules apply)
 - (2) Percentage owned by the shareholder immediately after the redemption must be less than 80% of the voting stock owned before the redemption (attribution rules apply)
 - (3) The percentage of common stock (voting or non-voting) owned after the redemption must be 80% of what was owned before the redemption
 - (4) Doesn't apply where there is series of redemptions
 - (5) **302(b)(2)(d)(2): Substantially disproportionate redemption** of stock
 - (a) defining “substantially disproportionate”
 - (i) After the redemption the shareholder must own less than 50% of the shares entitled to vote (e.g. if after the redemption he is still a majority shareholder, it does not apply)
 - (ii) What voting stock shareholder owns after the exchange must be less than 80% of what voting stock was owned before aka (voting shares after redemption/total voting shares outstanding after redemption) must be less than $.8 * (\text{voting shares owned before redemption} / \text{total voting shares outstanding before redemption})$ (this really means that it must suffer a more than 20% decrease in voting power)
 - 1. Stock with contingent rights is not considered to be voting, unless that contingent event occurs 1.302-3(a)
 - 2. a redemption of solely nonvoting stock can't be an exchange, because there won't be a reduction in the shareholders interest in voting stock
 - (iii) What total common stock shareholder owns after the exchange must be less than 80% of what common total stock was owned before aka (total shares after redemption/total total shares outstanding after redemption) must be less than $.8 * (\text{total shares owned before redemption} / \text{total total shares outstanding before redemption})$
 - 1. If there is more than one class of common stock, the 80% test is based on fair market value
 - 2. a redemption of solely nonvoting stock can't be an exchange, because there won't be a reduction in the shareholders interest in voting stock
- (b) fatal provision: if a shareholder has one type of stock but not another

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- (i) if shareholder doesn't own any voting stock, 302(b) doesn't apply according to 1.302-3(a)²³
- (c) safe harbors
 - (i) if the shareholder **owns no common stock** either directly or constructively, a redemption of voting preferred stock without a reduction in a 'shareholder's ownership of the common stock' may qualify as a substantially disproportionate redemption under section 302(b)(2) of the Code Rev. Rul 81-41
 - (ii) §1.302-3(a): if the shareholder makes a reduction of voting and nonvoting stock, it qualifies²⁴
 - (iii) exception: if there is a substantial redemption, a simultaneous redemption of non-voting stock will be treated as an exchange Rev. Rul 81-41
- (d) Mechanics
 - (i) Sec. 318 attribution rules are applicable (and to be applied in the way that attributes the most shares)
 1. timing: causal relationship (though not contractual relationship) deems two redemptions to be as one.
 2. Treat a series of redemption in the aggregate. 302(b)(2)(d)²⁵
 3. However, a planned retirement and redemption of shares does count. **Rev. Rul. 77-293**
 - iii) (or) **302(b)(2)(d)(3): Termination** of shareholder's interest combined with election by the shareholder (To completely terminate a family (usually) members interest in a closely held corporation, a shareholder can elect to waive attribution)
 - (1) Limits:
 - (a) entity and option rules still apply
 - (b) Three initial restrictions
 - (i) "ten year" look forward rule – apply to any interest other than as a creditor 302(c)(2) (this might be a bit more relaxed)

²³ 1.302-3(a) The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). See, however, paragraph (b) of this section. **For example, if a shareholder owns only nonvoting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraph (2), (3) or (4) of such section.** The determination of whether or not a distribution is within the phrase "essentially equivalent to a dividend" (that is, having the same effect as a distribution without any redemption of stock) shall be made without regard to the earnings and profits of the corporation at the time of the distribution. For example, if A owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under section 301 pursuant to section 302(d).

²⁴

(a) Section 302(b)(2) provides for the treatment of an amount received in redemption of stock as an amount received in exchange for such stock if--

- (1) Immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock as provided in section 302(b)(2)(B),
- (2) The redemption is a substantially disproportionate redemption within the meaning of section 302(b)(2)(C), and
- (3) The redemption is not pursuant to a plan described in section 302(b)(2)(D).

²⁵ **302(b)(2)(D) SERIES OF REDEMPTIONS.**--This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

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- (ii) if the stock **was not transferred for stock avoidance**, two additional limitations apply **302(c)(2)(B)**
- (iii) additional restriction #1: 10 year look back rule:²⁶ if they bought the stock within the past ten years from someone who would normally have their ownership attributed to them, then they cannot make the election
- (iv) additional restriction #2: at the time of the distribution, no person may own stock which is attributable to the distributee under the family attribution rules **if that related family member acquired any stock in the corporation within the 10 year lookback period**²⁷
- (c) examples of legitimate transactions
 - (i) a planned retirement and redemption of shares. Rev. Rul. 77-293²⁸
- (d) examples of tax avoidance transactions
 - (i) transfers stock of a corporation to a spouse in contemplation of the redemption of the remaining stock of the corporation and terminates all direct interest in the corporation in compliance with
 - 1. the transfer by a taxpayer of part of the stock of a corporation to a spouse in contemplation of the subsequent redemption of the transferred stock from the spouse
- (2) Mechanics
 - (a) Analyze immediately after the distribution
 - (b) Note: if there is more than one way to attribute shares, the way that attributes the highest number of shares should be used
 - (c) “ten year” look forward rule – apply to any interest other than as a creditor 302(c)(2) (this might be a bit more relaxed)
 - (d) redeemed shareholder must do three things
 - (i) must give notice to the service
 - (ii) must agree to notify service if they obtain a prohibited interest
 - (iii) must waive statute of limitations
- (3) Examples of “prohibited interest”
 - (a) providing post redemption services may disqualify Lynch v. Commissioner
 - (b) an agreement between the taxpayer (shareholder) and the remaining shareholders of the corporation calling for a member of the taxpayer's law firm to be appointed to the board of directors to protect the interest of the taxpayer as a creditor of the corporation

²⁶ **302(c)(2)(B)(i)** any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under [section 318\(a\)](#), or

²⁷ **302(c)(2)(B)(ii)** any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under [section 318\(a\)](#) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

²⁸ 77-293: The structure and legislative history of [section 302](#) of the Code make it clear that the purpose of [section 302\(c\)\(2\)\(B\)](#) is not to prevent the reduction of capital gains through gifts of appreciated stock prior to the redemption of the remaining stock of the transferor, but to prevent the withdrawal of earnings at capital gains rates by a shareholder of a family controlled corporation who seeks continued control and/or economic interest in the corporation through the stock given to a related person or the stock he retains. Application of this provision thus prevents a taxpayer from bailing out earnings by transferring part of the taxpayer's stock to such a related person and then qualifying the redemption of either the taxpayer's stock or the transferee's stock as a complete termination of interest by virtue of the division of ownership thus created and the availability of the attribution waiver provisions.

will be in violation of [section 302\(c\)\(2\)\(A\)\(i\)](#) of the Code, the redemption shall be treated as a distribution of property to which section 301 of the Code applies **Rev. Rul. 59-119**

- (i) difficult issue where there is a delayed payment of stock.
- (ii) Courts hold that mere postponement does not cause a classification as equity
- (iii) Leases, on an arms-length basis, a redeemed shareholder can lease property to a corporation Rev. Rul 77-467
- (b) If someone becomes a custodian under the UGTMA Rev. Rul 81-233
- (c) Trustee of corporate voting stock Rev. Rul 71-426
- (2) Safe harbors or not “prohibited interest”
 - (a) Maintaining a creditor relationship with the corporation
 - (b) As an executor, but virtue of stock held by inheritance. 302(c)(2)(A)(ii)
- (3) Entities waiving attribution when 100% of the interest is terminated
 - (a) Person who causes the attribution has to waive... and
- i) Requires that the entity (usually a trust) and the beneficiary agree to be jointly and severally liable²⁹
- c) **302(b)(2)(d)(4):** Redemption from noncorporate shareholder in **partial liquidation** (this creates parity with complete liquidations). Partial liquidations are treated as exchanges (not dividends)
 - ii) defining partial liquidations (302(e)(1))
 - (1) must be a plan
 - (2) must execute the plan in the current tax year or next
 - (3) must not essentially equivalent to a dividend
 - (4) must be the termination of one line of business (qualified trade or biz) (but the business must live on)³⁰
 - (a) raw land is not an active trade or business
 - (b) 5 year rule: must have been engaged in the trade or business for more than 5 years, so as to avoid acquisition of a dummy corporation and then immediate liquidation for sale or exchange treatment
 - (c) corporation must live on (ie engaged in another trade or biz)
 - (5) does not apply to subsidiaries. The terminated business must be run directly from the corporation
 - (6) does not apply to corporate-owned shares
 - iii) even a partial distribution to a shareholder will be treated as a sale or exchange
 - iv) there is no need for any surrender of stock
 - v) Partial liquidations, which under 302(b)(4) are treated as exchanges. Unlike the other requirements for exchange treatment, partial liquidations are measured at the corporate level
 - (1) Requirements for exchange treatment of partial liquidations
 - (a) Only distributions to non-corporate shareholders count

²⁹ 302(c)(2)(C)(II) each related person agrees to be jointly and severally liable for any deficiency (including interest and additions to tax) resulting from an acquisition described in clause (ii) of subparagraph (A).

³⁰ 302(e)(2) TERMINATION OF BUSINESS.--The distributions which meet the requirements of paragraph (1)(A) shall include (but shall not be limited to) a distribution which meets the requirements of subparagraphs (A) and (B) of this paragraph:

302(e)(2)(A) The distribution is attributable to the distributing corporation's ceasing to conduct, or consists of the assets of, a qualified trade or business.

302(e)(2)(B) Immediately after the distribution, the distributing corporation is actively engaged in the conduct of a qualified trade or business.

- (i) Corporate shareholders may not only get a dividend, but might have to reduce the basis in their stock
- (ii) Dealing with subsidiaries
- (iii) Distribution of liquidated shares of wholly owned subsidiaries to a parent corporation's shareholders do not qualify of exchange treatment 79-184
 - 1. However, a liquidation of a child corporation which owns stock in a grandchild corporation pass, resulting in a partial liquidation (if a subsidiary is liquidated, its assets can be deemed to be liquidated).
- (b) Pursuant to a plan
- (c) Must be some contraction of a business
 - (i) could be any contraction of the business, including proceeds from a fire
 - 1. can be a sale of one line of business
 - 2. safe harbor
 - (ii) must be assets
 - (iii) of an active trade or business
 - (iv) that has been in use for five years
 - 1. cannot have been acquired in the past five years in a taxable transaction
 - (v) no need to surrender stock
- (d) Occurs within the taxable year in which the distribution was adopted or the next one
- (e) "not essentially equivalent to a dividend" (but this requirement is based on whether it is equivalent at the corporate level)
- (2) pro rata distributions, can qualify as partial liquidations so long as they are actually contracting a business
- (3) when a corporation distributes appreciated property in a redemption (311)
 - (a) corporations recognize gain on distribution of appreciated property in a redemption as if the property had been sold for its fair market value (this applies to all distributions, even those which could be termed a partial liquidation)
 - (b) effect on earnings and profits 312(n)(7)
 - (i) look to shareholder level
 - 1. If it is treated as an exchange: 312(n)(7): a ratable share of the corporation's earnings based on the redeemed stock
 - 2. if it is treated as an ordinary distribution under § 301: the distributing corporation adjusts its EP in the same manner that other non-liquidating corporations would: They are reduced by the amount of cash and the principal value of any obligation, and by the greater of the adjusted basis and fair market value of any property distributed.
- d) The ordinary distributions take priority in determining earnings and profits Rev. Rul 74-339
- 5) **brother-sister stopgaps** Stopgaps on controlling corporations in § 304 which prevents controlling shareholders from triggering distributions to claim a basis recover and capital gain treatment of transactions, unless there is a significant reduction in corporate control
 - a) Unless they have significantly reduced their interest in the corporation, it does not matter
 - i) Terms
 - (1) Property is defined as money, securities, etc. but not stock
 - (2) Acquiring corporation is defined as one that acquires stock from a shareholder of another related corporation in return for property. In a parent subsidiary acquisition, the acquiring corporation is the subsidiary

- (3) Issuing corporation is defined as whose stock has been transferred. In a parent-subsidary corporation, it is always the parent.
- (4) Control is defined owning 50% of the combined voting power **or** 50% of the total vooe of all shares of all classes of stock 304(c)(1)\
 - (a) 318 attribution rules apply, but stock is attributed between a corporation and a 5% (rather than 50% shareholder)

ii) analysis

- (1) to see if 304 applies, see if the sale is "brother-sister" or "parent-subsidary" redemption
 - (a) bother-sister acquisitions: where persons in control of two corporations transfer stock between one corporation (issuing) and the other (acquiring)
 - (i) this would fail to satisfy any of 302(b)'s test for exchange treatment
 - (ii) 304 requires that the transaction be treated as a dividend to the extent of the acquiring corporation's EP, then to the extent of the issuing corporation's EP
 - (iii)consequences

- 1. if treated as a dividend
 - a. acquiring corporation takes a transferred basis controlling party
 - b. controlling party's stock's basis in acquiring corporation is increased by the basis of aquired stock that is treated as having been transferred
 - c. then reduce the earnings and profits as per 304(b)(2): first the acquiring corporation's earnings, by the amount of the vidident, then the issuing corporation's EP
 - d. acquiring corporation is treated as having acquired the stock by purchase and takes a cost basis under the normal? 1012
- 2. if as an exchange
 - a. Sec. 312(n)(7) limits it to an amount not in excess of the redeemed stock's ratable share of earnings and profits
 - b. but the code and regulations don't say which corporation matters

- (b) parent-subsidary acquisitions: when a controlled corporation acquires stock of its parent in return for property
 - (i) Control is defined owning 50% of the combined voting power **or** 50% of the total vote of all shares of all classes of stock 304(c)(1)
 - (ii) If a transaction is both a brother-sister and a parent sub-sidiary the parent subsidiary rules take precedence 304(a)(1) – but if the attribution rules do this (as they inevitably will), the brother sister rules will apply 1.304-2(c) ex. 1

- b) **302(b)(2)(d)(1):** Redemptions not [essentially] **equivalent to dividends**.--Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend. (this was the original provision, and it is explained by common law)
 - i) Davis: must be some meaningful reduction, and if a shareholder really holds the same amount before and after (even if he contributes capital), it is not a dividend
 - ii) A redemption of non-voting preferred stock is not essentially equivalent to a dividend when there is no reduction in the percentage of voting and noting stock, and when the redeemed shareholder remains in the control group Rev. Rul 85-106
 - iii) Determination of what is “meaningful” reduction is based on
 - (1) Right to vote and exercise control
 - (a) A reduction from 57 to 50% is meaningful, since this takes away a shareholders right to act unilaterally Rev. Rul. 75-502 (different if charter uses a 66% test)

You got this off

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- (b) Where a trust loses its rights to the trust experienced a reduction of its voting rights, its right to participate in current earnings and accumulated surplus, and its right to (a) share in net assets on liquidation, it is essentially equivalent to a dividend. Rev. Rul. 75-512. Where a shareholder has some voting interest, a redemption of non-voting shares won't be meaningful
 - (2) Right to participate in current earnings and accumulated surplus
 - (3) Right to share in net assets on liquidation
 - iv) (or) Partial liquidation
- b) When corporations redeem stock, there are two possible consequences
 - i) Sale or exchange, which results in capital gain or loss (unless is a dividend)
- 6) Realizations by corporation and shareholder of a non-liquidating distribution
 - a) **Realization by corporation:** realize gain equal to the amount fair market value of the property minus the basis. 311(b) (this means that there must be some corporate level tax on the property)
 - i) Limited to avoid a negative basis: if the shareholder assumes a liability, the maximum fair market value of the property can be the liability
 - b) **Effect of a non-liquidating distribution on the shareholder's basis**
 - i) effect on EP: gain recognized increases or decreases current EP by the adjusted basis of the distributed property. **but** won a distribution of appreciated property, earnings and profits is reduced by its fair market value. 312(a)(3). – net result: same as if the corporation had sold the property and then distributed the cash to the shareholders
 - ii) exceptions that reducing a distribution corporations EP in determining tax consequences of distributions to large shareholders
 - (1) 312(k): depreciation deduction – do not apply to a 20% corporate shareholders 301(e)
 - (a) 20% corporate shareholders 301(e) is anyone entitled to a dividends received deduction either directly or indirectly and under 318 received either 1) stock in distributing corporation possessing at least 20% of the total combined power or 20% of the total value of all the distribution corporations stock, except non-preferred stock
 - (2) 312(n): other timing deductions – do not apply to a 20% corporate shareholders 301(e)
 - (a) 20% corporate shareholders 301(e) is anyone entitled to a dividends received deduction either directly or indirectly and under 318 received either 1) stock in distributing corporation possessing at least 20% of the total combined power or 20% of the total value of all the distribution corporations stock, except non-preferred stock
 - c) realization by sh: shareholder basis is the fair market value at the date of the distribution, reduced by any encumbered liabilities 301(c)
- 7) stock dividends (splits): In general, a stock split cannot be taxed since it is really creating more pieces of paper. Eisner v. Macumber (common) Koshland (preferred); Towne (if they are given something they did not have before, it is more); Gowran (preferred stock to common shareholders counts as more). **In other worse a stock dividend does not result in a realization event**
 - a) But, if there is a change in the shareholder's interests, it DOES result in a stock dividend.
 - i) When stock distributions are includible in gross income (because the shareholders interests have either changed, or have the possibility of changing) , it is treated as per § 301 (dividend to the extent of earnings and profit (but not below zero), return of basis, than capital gain)
 - (1) Right to purchase additional stock count as an increase
 - (2) Rights of others to purchase stock count as an increase

- ii) There is a hair-trigger upon which shareholder has a disproportionate effect. Shareholder, for these purposes includes one with 1) someone who holds stock 2) someone who has the right to acquire stock; 3) someone who has the right to convert a note to stock
 - (1) Any election of any shareholder to acquire stock or property will trigger taxable treatment
 - (2) Shareholders who participate in reinvestment plans are taxed. Rev. Rul 78-375
 - (3) Anything that ends up giving some shareholders an increased share and others more property will be taxed (this means that if some shareholders have the option of doing something, some will have a disproportionate effect)
 - (4) Doesn't matter if they are not pursuant to a plan
 - (a) But, if distributions are more than 36 months apart, a safe harbor is created wherein they are presumed to not be part of a plan. Reg. 1.305-3(b)(2)
 - (5) If some shareholders receive common and others receive preferred stock, then they are deemed to have a disproportionate effect
 - (a) Preferred stock is defined as stock that does not participate in corporate growth
 - (6) Preferred stock is generally taxable – unless it is increased to take account of a dividend or stock split under § 205(b)(4)
 - (a) A change in conversion ratio is deemed to be a stock distribution, unless it can be established that it is to take into account a split
 - (7) A distribution of convertible preferred stock is presumed to have a disproportionate effect, and therefore taxable unless the taxpayer can establish under 1.305-6(a)(2) that it is not predictable
 - (8) Imputed dividends: preferred stock that is issued at a discount, but no dividends are paid until distribution
- i) Distribution of taxable rights
- b) Effect of nontaxable stock dividends (e. g. where there is no increase in voting power, just more paper)
 - i) In a nontaxable distribution there is no change in earnings and profits
 - ii) Shareholders basis in stock distributed: will be allocated between old shares and new shares based on their fmV on the date of distribution. § 307(a)
 - iii) Shareholders holding period of the new stock is tacked on to the holding period of the old stock (this means that stock can get the 306 taint)
- c) Characterization of taxable stock dividends
 - i) Effect on corporation
 - (1) Corporation recognizes no gain or loss
 - (2) Corporation can reduce its EP by the fmV of what is distributed. 1.312-1(d) (this might be very lower)
 - ii) Effect on shareholders of stock distribution
 - (1) Shareholders basis in stock distributed: will be allocated between old shares and new shares based on their fmV on the date of distribution. § 307(a)
 - (2) Shareholders holding period of the new stock is tacked on to the holding period of the old stock
 - (3) Rights
 - (b) Distribution of rights does not get included in gross income, unless some shareholders get cash, and others get rights in that distribution

- (c) Usually there is an allocation of basis between the underlying stock and the and the rights in proportion to their relative fair market values on the date of distribution. (unless de minimus rule). 1.307-1(a). If the rights lapse, no loss.
- d) Rights have a zero basis if their fair market value is less than 15% of the stock with to which they are distributed, unless the shareholder elect to allocate between the underlying stock and the rights in proportion to their fmv
- 8) Redemptions of stock
 - a) Differentiating between a redemption and a distribution (a.k.a. a dividend to the extend of earnings and profits)
 - i) A distribution must satisfy these five criteria to be a distribution as opposed to a redemption
 - (1) distribution
 - (2) of property (as defined in section 317(a))
 - (3) money or other tangible property
 - (a) does not include stock or rights to acquire stock
 - (5) made by a corporation
 - (6) to a shareholder
 - (7) in his capacity as a shareholder
 - ii) Amount of distribution: Calculation: amount is amount of cash received by shareholder plus the fair market value of any property received
 - iii) does not include distributions of rights to stock or distributions of stock (stock dividends)
 - b) bifurcation possible for distributions without fmv: To the extent that a corporation distributes property to its shareholders and doesn't receive fair market value for it, that is a dividend, and under Sec. 316, the transaction will be bifurcated into the transaction and the dividend
- 9) transfers of shares between parties
 - c) Selling stock to a related party does not result in a realization of gain or loss Sec. 267³¹
 - d) Corporations that make distribution, under 301, the entire amount is taxable.
- 10) corporation's redemption of stock
 - a) Redemptions: a buyback of the shares from the corporation. This means that the shareholders share in the corporation does not change (this is treated like dividend, as opposed to a buyback, in which the actual control changes), .
 - b) When redemptions will be treated as an exchange
 - i) When it is an exchange: so that the shareholder will recognize a capital gain or loss between the amount of distribution and the shareholders basis. (non-corporate shareholders prefer, corporate shareholders prefer b/c they get the drd)
 - ii) When it is not under 302 (an exchange), it falls under 301, which will be treated as a distribution (possibly a dividend) dividend.
 - e) Test to determine whether or not it is an exchange (four statutory tests in 301(b)(1)-(4), they focus how the shareholders interest has changed, and whether there has been a meaningful reduction in interest (must analyze under constructive ownership rules)
 - i) Each shareholder is analyzed individually, but ownership can be attributed to them
 - ii) Constructive ownership: attribution to determine whether or not there has actually be a change in proportion of ownership -- with the exception of families, must reattribute each

³¹ **267(a)(1) DEDUCTION FOR LOSSES DISALLOWED.**--No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.

person's interest in what they have to the succeeding generation. (if there is more than one way to attribute shares, attribute them in the way that gives them the most shares).

(1) All individuals own stock that is owned by spouses, children, grandchildren and parents.

Siblings are not considered to be "family" for these purposes

(c) No double family attribution (since this would mean that everyone is related)³²

(2) Option attribution: people are deemed to own shares that they have options in. If both option and family attribution applies, than option attribution applies (so family attribution can be used later)³³

(3) Entity to owner attribution (no sideways attribution – co-partners do not have interests in what their partners own, except as a member of the partnership)

(a) From Partnerships to their members: all individual who have an interested in a partnership are considered to own stock that the partnership owns in proportion to their beneficial interest

(b) From trusts to beneficiaries: Trusts: all individual who have an interested in a trusts are considered to own stock that the partnership owns in proportion to their beneficial interest

(i) Doesn't matter how small or remote, it is considered owned to the extent of their interest in the trust

(ii) Must have present, not contingent interest

(c) From corporations to individuals: : individuals are considered own the stock of corporations that they own more than 50% of

(4) From individuals to entities (no sideways attribution – co-partners do not have interests in what their partners own, except as a member of the partnership)

(a) To partnerships: all stock owned or constructively owned by partners is considered owned by a partnership or the estate

(b) To estates: all stock owned or constructively owned by partners is considered owned by a partnership or the estate

(c) To trusts: if an individual has more than a 5% interest in the trust it is considered to be contingent

(d) To corporations: if the corp is more than 50% owned by the individual, it is deemed to be an owner

c) Options: individuals who own an option are considered to be owning that sock

11) 306 taints: the anti-bailout provisions. Distributions of stock may be treated as ordinary income when sold if it would have been treated as a dividend

a) defining § 306-tainted stock

i) preferred stock distributed to a shareholder as a tax free stock dividend under § 305. (common stock, since it participates in corporate growth, doesn't count.)

(2) If the stock has a limited right to dividends it is preferred

(3) If the corporation has a right of first refusal it is common. 76-386

(4) In general, any dividend other than common on common

³² 318(A)(5)(B) **Members of family.**--Stock constructively owned by an individual by reason of the application of paragraph (1) shall not be considered as owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock.

³³ 318(A)(5)(D) **Option rule in lieu of family rule.**--For purposes of this paragraph, if stock may be considered as owned by an individual under paragraph (1)(family) or (4)(options, it shall be considered as owned by him under paragraph (4).

- (5) Does not include stock with **no current or accumulated** EP (e. g. would no part of the stock been a tax free dividend for the year in question)
- iii) Any stock whose basis is determined with reference to the 306 stock is considered to be 306 stock
 - (1) 306 stock is removed on the death of the shareholder, since it takes a date-of-death basis under 1014
 - (2) any stock which is received in a reorganization or division is 306 stock if the effect is the same as a receipt of a stock dividend, or if the stock was received in exchange for 306 stock
- iv) stock received in a reorganization
- v) preferred stock received in a 351 exchange is covered under § 306(c)(3). If the receipt of money instead of any part of the stock would have been treated as a dividend, then it will be § 306 stock. In this case, one must apply the rules in § 304 (brother-sister acquisitions)
- b) exceptions to section Sec. 306
 - (1) exemptions:
 - (a) 306(b)(1): total withdrawal from the corporation (since the shareholder is not taking bailing out earnings)
 - (b) complete liquidation
 - (c) contributions to capital
 - (d) tax free 351 transfers
 - (e) if the IRS thinks that it was not tax avoidance
 - (i) Fireoved: maintaining effective control is not grounds for relief
 - ii) exception: stock sold in a taxable transfer erases the taint
 - iii) selling entire interest in corporation
 - (1) must not even have effective control
 - iv) redemption in complete liquidation
 - v) disposition that are treated as non-recognized under 351
 - vi) distribution that is coupled with a later disposition or redemption that is not part of a plan
- c) the power of § 306: 306 taint (avoiding a preferred stock bailout wherein a corporation would distribute preferred stock to shareholders, would would sell the stock and report a long term capital gain (since a portion of the shareholders basis was allocated to the preferred stock) and corporation would redeem the preferred stock from the 3rd party. 306 labels stock with bailout potential, and 306 tainted stock will be treated, upon its disposition not as ordinary income but as a capital gain.
 - i) if sold: treated as ordinary income to the extent of its ratable share of the amount that would have been a dividend if the corporation distributed cash instead. The rest is treated as gain from the sale or exchange of stock
 - (1) sh must look back to the time of the distribution and determine what would have come out of earnings and profits
 - (2) the ordinary income is not eligible for a dividends received deduction, and a corporation can't reduce its earnings and profits when its 306 stock is sold
- d) Effect of 306 stock
 - i) If it is sold: Ordinary income, not capital gain when stock is sold to the extent of the stock's "ratable share" of the amount that would have been a dividend if the corporation distributed cash in an amount equal to the fair market value of the stock at the time of the distribution.

The balance is treated as a reduction of basis of the 305 stock, and anything else is treated as gain from an exchange.

(1) Must look back to the original time of the distribution

(a) in determining the date that the distribution was made, the date that the shares are surrendered is irrelevant, the date of distribution is what matters. Rev. Rul. 68-348:

(2) No Dividends received deduction available

(3) No reduction of Earnings and Profits by the corporation allowed

ii) if redeemed: treated as a distribution taxable to the extent of current or accumulated earnings and profits in the year of the redemption

(1) If it is redeemed (really a two-step process to withdraw cash): treated as a 301 distribution

(2) 1.331-e: if a shareholder has acquired stock at different times, gain or loss is determined separately. This is important for holding period purposes. The actual amount of gain or loss should be the same, whether you aggregate or do it on a block-by-block approach.

(Doesn't usually matter since LT and ST CGs can offset each other)

b) purging 306 taint

i) sale

ii) death

12) liquidations of a subsidiary

a) liquidations of one corporation into another should be a tax free event (e. g. c2 liquidates distributing its assets into Corporation)

i) two reasons why it should be nontaxable event

(1) dividend received deduction

(2) we were taxing, in the first case, something where the assets didn't remain in corporate form

ii) there is no need to tax if any gain remains there, and the way we do this is under a carryover basis, under a 332 liquidation

(1) in order to qualify for a liquidation under 332, the liquidation must meet two requirements under § 332(b).

(a) the corporation receiving the property, was, on the date of liquidation was the owner of stock as per 1504(a)(2) (as long as you own 80% of the vote, and 80% of the value you can file a consolidated return)

(i) the first requirement is that Corporation own that much of the property (80%)

(b) second requirement: liquidation take place within 1 taxable year **or** take place within three years of when the first distribution was made (does not need to be the same year in which the plan was adopted).

(i) If they want to do it within the three year period, they have to waive the statute of limitations, and might be required to post a bond

(c) Failure to meet these requirements will result in the liquidation being retroactively disqualified

(i) Also, will be disqualified if the corporation loses control

(ii) There actually is a formal plan of liquidation under § 332 (§ 332(b)(1))

(2) 332: no gain or loss is recognized by a corporation on receipt of property distributed by another corporation (assets are not leaving corporation form, and we have another chance to impose the corporation tax)

(a) 334(b): basis of the property in the hands of the distribute shall be the same as if it is in the hands of the transferor (and a carryover basis and a carryover holding period)

- (i) 381 (there are other carryover attributes, not applicable here such as NOL that would carry over to the corporation)
- (3) 1.332-5: minority shareholders are taxed under 331
- (4) consequences to the liquidating corporation.
 - (a) § 337: no gain or loss shall be recognized to an 80% distributee.
- (5) 336(d)(3) prevents any loss from being recognized only any distribution, on any distribution in such liquidation – in distribution property that it had a gain on
 - (a) can't manipulate the property by dividing up the losses (§ 337)
- (6) exception: 337(b)(2) and 337(d)(2): a gain is recognized where the property is transferred to either a tax exempt or a foreign parent (because this loses the chance to tax it any layer).

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