Corporate Taxation Outline

I. Overview of Enterprise Taxation
How is corporate income federally taxed?
Three categories in the Code:
1. Sole proprietor (individual owner)
2. Partnership
3. Corporation

A. Conduit v. Entity Taxation

1. Sole Proprietorships
Business directly owned by proprietor
- Taxed under §1, Schedule C – normal income tax
- Business tax information reported with personal statements
- Joint owners may be treated individually as sole proprietors for tax purposes
  - Joint owners may individually elect to use different accounting methods, etc. on their tax forms
  - Cf. Partners, who are bound by joint firm decisions

2. Partnerships
Pass-through or Conduit taxation
Calculated as a business, but taxed to the individual partners
- 701 – not taxed as income of the firm directly, but as income to the partners.
- 702 – in determining income tax, each partner is taxed according to their interest in the business on a pro rata basis of business income or loss. See also 703, 704.
- Key: Allocation to partners of distributed share
- Partners have to report distributive share of profit income, even if not actually distributed. If partnership retains earnings, partners are still taxed.

3. Corporations
11(a) – corporation computes its profit or loss and is taxed as an entity
11(b) – “progressive” tax schedule, but most taxable corporations (except the largest ones) are subject to a flat rate of 34%
The flip side of §11
61(a)(7) – dividends and the double tax. Corporation is taxed once, and earnings taxed again when distributed as income to individual shareholders

A. C Corporations
“Regular corporations”
i. Corporate earnings are subject to “double tax,” once on corporate earnings, and once more when earnings are distributed to shareholders through their income taxes.
- Models of double tax. Assume TP owns all shares of Corp X, which made $100 in profit this year. Assume applicable tax rates are corporate, 46%; individual, 70%; LTCG, 40%:
  o Dividend Distribution – all after tax profits distributed to shareholder
    Simplest form – a.k.a. “double tax”
    CIT 46
    Dividend 54
    PIT 37.80 (.7 x 54)
    TP’s after tax proceeds 16.20 (54 – 37.80)
    Combined effective tax rate (sum of total taxes as percent of original income) – 83.8%
  o Deductible Distribution – X distributes all $100 to TP as rent paid (deductible under 162(a)(3)) for premises leased from TP – still paid out to shareholder, but colored as a business expense instead of a dividend. Most common in closely held corps, tends to be self-policed by unrelated shareholders in large and widely held corps
    Disguised dividend – modified pass-through when business pays expenses to shareholder
    CIT 0
    Distribution as rent 100
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PIT 70
TP’s after tax proceeds 30
**Combined effective tax rate – 70%**

Are there any limits on the DD strategy? Only if closely held corp.

→ Reasonableness – “rent” in this situation would be subject to a substance test in review. Tax consequences are not controlled by title, so if the corporation were to distribute a gross over amount to an interested shareholder for any otherwise legit purpose, they would be improper as to the amount of excess distribution. Substance over form question.

- **Retained Earnings** – X retains and reinvests the $100; TP sells all stock in X at end of year

  *Capital gain bailout*

  CIT 46
  RE 54
  Price paid for add’l assets 54
  PIT 15.12 (.7 x .4 x 54, applying LTCP tax preference)
  TP’s after tax proceeds 38.88 (54 – 15.12)

  **1001** – realized gain/loss – sales proceeds go up by the amount of reinvestment, but the individual basis is the same as the amount she paid for the stock when originally bought.

  **Combined effective tax rate – 61.12%**

  Note: the one year mark is only required of the stock. In basic tax, the determinative factor is whether the property sold is a capital asset. In this case, the asset is the stock and not the $54 in RE.

**Key to profitable following of RE strategy is based SOLELY on higher/lower PIT/CIT rate differential!**

- Are there any limits on how long may the RE strategy be taken advantage of?
  - Penalty taxes (accumulated earnings tax 531/532/535(a),(c)(1)/537(a)(1), personal holding company tax AET/541/)
    - AET: Congress encourages retention to foster “reasonable anticipated” (from 537(a)) internal growth (includes internal expansion and acquisitions according to Treasury regulations), but excessive abuse of RE will result in massive tax consequences through the AET formula above
      - Note – subjective test in 532 applicable only to corporations purposely formed or availed to avoid tax liability!
    - PHCT: No subjective test as in AET. Two part test (% of income that is PHC income, 5 or fewer controlling stockholders test)
  - Corporate redemption of sock (another distribution, but not as a dividend)
  - Liquidation of corporation – exchange stock for assets

Because of the retained earnings model, corporations have traditionally been used as **tax reduction** vehicles. Shareholder nets value form sales of stock (1001 capital gain), and not in the more highly taxable form of dividends. Less tax than if she had been sole proprietor, less tax than the other two strategies.

**Consequences of a corporate tax regime: tax rates. Unlike the S corporation, the C corp may screw up vertical equity because it disproportionally taxes equity holders not according to their respective stake, but unilaterally. This may disadvantage small stakeholders (like geriatrics holding a few shares of stock).**

B. **S Corporations**

If there is no corporate expectation of advantageous RE scheme, then may elect to incorporate as S corp. Avoids tax liability on corporate earnings, but earnings must be reported. Shareholders are then taxed on their pro rata share of the corporate earnings no matter the income’s disposition (distributed to shareholders or not). The character of the monies reported (loss, gain, deduction, credit) is retained in the taxpayer’s hands.

- Limitations
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- Eligibility – Cannot incorporate as S if more than 75 shareholders, one or more is foreign, any shareholder is not an individual, more than one class of stock exists. All shareholders must approve the S structure. 1361(a)
- Losses – shareholders cannot deduct losses in C corp because corporation is separate entity, but S corps materialize losses as personal losses against unrelated income. 172. Limited losses allowable as offset to percentage ownership. 1366(d)(1). Less generous than partnership loss allowances, though.
- Special allocations – bars allocations because of only one class of stock. 1361(a).
- Owner-firm transactions – still controlled by C rules, while partnerships aren’t. 1371(a).

→ Conduit tax regime ensures that you pay a rate that is proportionate to your overall income, unlike the note above showing the frustration of vertical equity.

4. Partnerships and Limited Liability Companies
   A. Partnerships
   B. Limited Liability Companies
     - Personal service corporations (PSCs) generally follow deductible distribution strategy to the hilt

5. Policies
   A. The double tax – treating corporations as separate entities form their shareholders. Central theme in corporate taxation. Critics say it is inefficiently biased 1) against corporate as opposed to noncorporate investment, 2) in favor of excessive debt financing for C corps, and 3) in favor of RE at the corporate level rather than dividend distribution.
   B. Higher personal rates create incentive for corporate investment
   C. Favorable capital gains rates create incentive for long-term investment
   D. Nonrecognition – gains or losses not taxable until realized in sale, exchange, or other event that makes them easily measurable

6. Common law
   A. Sham transaction – transaction that never occurred but is represented by the taxpayer as having occurred. Usually reserved for more egregious cases, typically defined where court finds that taxpayer was motivated by no business purpose other than obtaining tax benefits, and there is no substance to the transaction because no reasonable possibility of profit exists
   B. Substance over form – a business’ definition of a disputed transaction is not determinative. What the transaction accomplishes, rather than what it portends to be, if the common law key to review
   C. Business purpose – no valid business purpose but to create tax savings
   D. Step transaction doctrine – combination of formally distinct transactions to determine tax treatment of the integrated series of events. Interrelatedness of events to allow this test is a gray area (some courts require binding legal commitments enforcing the whole of the transactions, others simply look for “mutual interdependence”)

B. The Corporation as a Taxable Entity 1-27

1. Corporate income tax
   A. Rates 11(b)(1)
      | Taxable income       | Rate  |
      |----------------------|-------|
      | 0 to $50K            | 15%   |
      | $50,001 to $75K      | 25%   |
      | $75,001 to $10M      | 34%   |
      | * $100K to 335K      | add 5%|
      | * $15M+              | add lesser of 3% or $100K |
      | $18,333,333          | 35% flat rate |

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* - Rate “bubbles” to wipe out the advantages of the first $75K in income at the earlier rates. See 11(b).

B. **Determination of taxable income 63(a)**
   Computed similarly to personal income taxes, with following exceptions:
   - No personal or dependency exemptions, medical expense, spousal support, etc., deductions
   - No standard deduction
   - 70-100% deduction allowed to corporate shareholders for subsidiary dividend distribution to parent corp
     - Effect of 70% dividends received deduction is that corps are subject to 10.2% maximum tax rate on dividends (34% rate x 30% includable portion of dividends). 243(a).
   - 10% deduction limit to charitable contributions
   - $1M per year limit to publicly traded corps for executive compensation
   - Corp losses only deductible to extent of corp gains 1211
     - Excess may be carried back three years or forward five

C. **Special features of CIT**
   - Lower brackets of §11. PSC taxed at 35% - not eligible for graduated rates. 11(b)(2), 1561.
   - Restricted accounting methods. 448. C corps generally not allowed to use cash method accounting – must use accrual method accounting. C corps can generally afford to pay someone the extra money for accrual, and it’s more accurate.
   - C corp can pick fiscal year, PSCs have to use calendar years. 441(i).
   - Distributions from subsidiaries – see above, 243(a). Only available to C corps.

D. **Fairness and CIT**
   *The breakdown of horizontal and vertical equity arguments for scaled taxes*
   - Large corp with thousands of shareholders retains all earnings – violates vertical equity
   - Two individuals, A & B, own all stock of corp A and corp B, respectively. Corps A & B have equal revenue and operating expenses
     - Additionally, need to know what each corp is doing with its earnings
     - Assume that both corps distribute all after tax profits as dividends. Would still provide horizontal equity.
     - Assume A capitalize din stock exclusively; B partly in stock, but mostly in corporate debt. B will see some deductible to the extent of corporate debt, while seemingly economically identical A will not. Violates horizontal equity

E. **Incidence of CIT**
   - Short run – burdens shareholders if industry is perfectly competitive (commodity) or unregulated monopolies
   - Long run – shifting of burden to owners of ALL capital
     - X corp → current dividend distribution
     - Y → partnership
       - Differential will occur until after tax implications equalize and the cost of capital is resultantively increased because of higher supply of capital (less tax, more in pocket, less need for financing, more cash in bank stockpiles, lower interest rates)

F. **Economic neutrality and inefficiencies in allocative resources**
   - CIT favors unincorporated over incorporated businesses
   - CIT favors RE over current distribution
   - CIT favors debt rather than equity capitalization
   - Net result is estimated 25% deadweight loss in total CIT tax revenues

2. **Alternative minimum tax 55, 56(a)(1)(A), (c), (g)(1-3; 4(A-Ciil)), (5), (6); 57(a)(5-6)**
   - Flat rate tax imposed on a broader income base than the taxable income yardstick used for the regular corporate tax. Payable only to the extent that it exceeds corp’s regular tax liability.
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- AMT income (AMTI) taxed at 20% after initial $40K exemption. AMTI = CTI + tax preference items – certain timing benefits from regular taxation
- Adjusted current earnings (ACE)
- Reread pp. 16-17. Confusing.

3. Multiple corporations
Ownership tests prevent splitting corporate profits among smaller corporations to minimize tax liability. 11(b)(2).

4. S corporation alternative
Avoids ACE/AMT maze by passing corporate tax through to personal shareholder level. General forms:

Problem 19
(a) Boots, Inc.’s taxable income $900,000
   Regular tax liability $
(b) 
(c) 
(d) 

5. The integration alternative
Possible integration of corporate and individual tax systems into single, coherent, and equitable system.

A. Distribution relief
   a. Dividends paid deduction to corporations (like interest payments). Would neutralize debt capitalization favorableness. Eliminates CIT
   b. Dividends received exclusion – Eliminates SH tax
   c. Imputation-credit system – CIT remains, dividends taxed on SH, but dividend is increased to comp for the CIT and CIT is treated as a credit against SH’s tax liability (i.e. $100 profit * .35 = $65 dividend, but “gross up”/impute dividend by CIT, so SH reports $100 dividend on which they can claim the CIT as credit. SH at 40% taxable will have $35 credit, then simply pays $5 difference)
   d. Distribution relief alternatives:
      - Corp and SH taxes equal,
      - All shareholders taxable, AND
      - No corp tax preferences, then all three forms above yield same result.

B. Shareholder allocation
Conduit tax treatment, but difficult to determine appropriate allocative tax treatment because of disparate stock class treatment. General view is that unless different classes of stock are outlawed, current complex capital structures prevent this type of integration. “Best in principle” winner, Cannes 2002.

C. General capital tax
Treasury’s 1992 Comprehensive Business Income Tax (CBIT) proposal. Addressed bias between distribution and RE strategies. As follows:
   a. Deny deduction for any payments to capital owners (interest/dividends),
   b. Interest and dividends received excluded from second round of taxation
   c. Apply system to all business, regardless of business form

C. Corporate Classification

1. In general
Federal classification of business entities does not hinge on state law labels. However, state law governance of legal relationships provides the criteria that the federal classifications are based on.
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These federal adaptations of the “overall resemblance” test are contained in Reg. 301.7701-1 through -3. It lists six characteristics normally found in a “pure” corporation:
- Associates (two or more persons in shared control and ownership)
- An objective to carry out the business and divide the gains therefrom
- Continuity of life
- Centralization of management
- Limited liability
- Free transferability of interest (shareholder ability to dispose of their shares)

A business will thus be treated as a corporation under federal tax laws if it more closely resembles this organization than it does a partnership. This process of distinguishing between the two has caused problems.

2. Corporations v. partnerships

A. Historical standards
   Absence of first two characteristics will prevent organization from classification as an association. When distinguishing between associations and partnerships, the last four are considered and weighted equally. Classification as an association will only occur if three of the remaining four are present.

B. Limited liability companies
   IRS classified as partnerships. Principal benefit of LLC over limited partnerships and S corps (other pass-through entities) is that owners have limited liability, but may participate in business management. Also, no strict eligibility requirements like S corps, and flexibility in taxation under Subchapter K. Looks to be the dominant organizational form for the foreseeable future.

C. “Check the Box” regulations
   Because of thinning lines between state law definitions of corps and partnerships, IRS chucked the four-factor system in favor of default tax classification as partnerships unless electively “checking the box” to be taxed as a C corp. This is only for businesses that have not incorporated under some state incorporation law, because to change the regulations governing them would free them from the statutory definition of “corporation” in 7701(a)(3) and frustrate the tax code. IRS regs have no authority to revise statutes, but as a matter of policy are probably indicating that they’d like Congress to change the statute itself.

   Businesses may make this election after functioning as an S corp in the startup phase for loss pass-through purposes. See 301.7701-3.c.iii – iv.

D. Publicly traded partnerships
   Temporary loophole around double tax regime was amended quickly by congress when interest began to be traded often like stock. PTPs are reclassified as corps when interests are either 1) traded on an established securities market, or 2) readily tradable on a secondary market. Exceptions from reclassification on 90% or more of gross income is from passive income items (dividends, rent, etc.).

3. Corporations v. trusts
   301.7701-4. No double tax on trust income. Distributions are taxed to the recipient to the extent of the trusts “distributable net income.” If trust income is accumulated, then it is taxed at §1(e) rates, and normally not taxed again if the accumulated earnings are distributed later. If the trust becomes an active trade or business, it is taxed as a normal corporation.
   - Two classes of trusts: 1) Conserve property (301.7701-4.a), and 2) “Active business” trusts (301.7701-4.b). Regs suggest that ultimate test is whether state law trust is a state law “business entity”.
   - Other considerations for trusts v. corporations: 1) active conduct of business, and 2) voluntary association of business partners = corporate tax levied against trust. Spendthrift trusts are stuck in this conundrum. See Estate of Bedell, 86 T.C. 1207 (1986).
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Problem 36
(a) No double tax on the recipients. Trust was already taxed.
(b) 
(c) 

D. Recognition of the corporate entity
Ambiguity in relationships between agents and corporations examined.

Bollinger 37 (1988)
Shell corporation used as agent for partnership to avoid state usury laws and allow acquisition of bank financing. When losses were incurred, Bollinger applied the accelerated depreciation deductions from the real estate to his personal taxes (like a partnership) on income from other sources. IRS disallowed because of state law formation as partnership, saying that losses must be attributed to corp. Tax court overturned, US affirmed. If a corp is legitimately formed for reasons other than specifically avoiding tax consequences, and the corp is acting as an agent for certain asset purposes as clearly indicated in corp charter, no abusive avoidance scheme exists.

Æ Why not an S corp? Severe limitations on pass-through for losses (not for gains, though).

II. Taxation of C Corporations

Quick taxable income overview
Income measurements –
Realization, look to intro language in 61, then 61(a)(3), 1001(a). Tax reckoning only when investment is terminated.
Recognition, 1001(c)
Definition of 1001(c)*: Amount realized → 1001(b) + case law
- Adjusted basis → 1011 → 1012, plus or minus adjustments in 1016
Gain/loss
Cost of property to extent you received more than you put in.

Definition of gross income: Amount spent in consumption + change in taxpayer’s wealth.

* – Even though there is a realized gain, congress may choose to pass on taxing it. Most commonly because gain is realized in technical sense, but investment continued in similar form. See e.g. 1031(a) (lifetime exchanges), 351 (transfer to corporation nonrecognition). Every nonrecognition rule has an associated basis rule. See e.g. 358 (associated basis rule for 351).

In corporations, 351 nonrecognition may occur if a transferor exchanges capital assets (as defined in 1221, minus enumerated exceptions) for stock that is in essence merely a change in form of the initial investment in the transferred property. The catch is when the transferor’s basis in the property is different than its FMV, and is contingent on what the disposition of that property is after the transfer (i.e. transferor immediately sells the received stock and must realize and recognize the FMV gain before he/she can recover their basis).

A. Corporate Organization

1. Introduction to 351
351(a), (c), (d)(1)-(2); 358(a), (b)(1); 362(a); 368(c); 1032(a); 1223(1), (2); 1245(b)(3).
Nonrecognition allows for avoidance of taxable consequences for raising business capital if the exchange doesn’t substantially alter the nature of the transferor’s investment. Normal nonrecognition policy consideration is that if swap is for such a similar form of investment, then the deferral in accumulated value is warranted until this new investment is terminated for something substantially different in form. 351 broadens this policy by nonrecognition of substance changes to encourage business investment. The essence of 351 is to ascertain whether a transferor has a sufficiently continuous relationship with the property transferred to a corporation to justify nonrecognition treatment, or whether that transfer has severed the relationship with the transferred property, thereby
justifying recognition of a gain. Three requirements for nonrecognition benefits: 1) transfer of property, 2) in exchange solely for stock, and 3) transferee control of corp immediately post exchange.

**The corporate partner to 351**

1032 is corporate nonrecognition statute – issuance of stock by corporation always a nonrecognition transfer. 362 covers the basis for recognition by the corp – the transferor’s basis travels with the transferred property, no matter the FMV. This is the crux of the problem in Intermountain Lumber, infra, where the transferor wants recognition to avoid immediate taxes, but the corp wants to avoid so they aren’t stuck with a lower basis than FMV (and cannot use depreciation of the more valuable FMV figure as a tool to write off current taxes).

Property transferred retains its transferor’s basis while now in the control of the corp. Any gain or loss on that property will be realized from the transferred basis. Same deal with transferees. If a transferee exchanges property with a basis of $10 and FMV $100 for $100 in stock, then upon sale of the stock (at $100) transferee must recognize $90 gain (as in $100 gain – $10 original basis).

1. Nonrecognition in 351, basis for recognition in 358.
2. Be aware of both sides of transaction (transferor and transferee tax consequences)

**Problem 46**

<table>
<thead>
<tr>
<th>Realized gain/loss</th>
<th>Recognized gain/loss</th>
<th>Adjusted basis in property received</th>
<th>Character of property received</th>
<th>Holding period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1001(a)</td>
<td>1001(c), 351</td>
<td>1012</td>
<td>1221</td>
<td>1223</td>
</tr>
</tbody>
</table>

“Holding period” describes the tax status that differentiates capital gains from LTCG. If a transferred item is a capital asset under 1221 (as opposed to normal income property), then the period for which the transferor held that property prior to transfer may be “tacked on” to the stock received in the exchange. Upon sale of the received stock, the total holding period will determine whether the realized gain finally recognized is treated as short-term capital gains, or the lower bracketed LTCG.

(a) Distributor computations

A – Cash purchase = no material change. 1012 says basis in cash purchase is cost
B – Will realize $5K gain on sale of stock, none recognized. Character of property received changes from inventory (which would have become regular income at sale) to stock with possible preferential tax treatment under RE scheme
C – Must realize previously unrealized $5K loss immediately, won’t recognize until stock is sold
D – $25K realized, 0 recognized. Capital asset unless D is realtor. Won’t be able to claim a $5K loss because D has already amortized $5K in depreciation on the transferred property. Looks like D meets holding period. 1245(a)
E – $18K realized gain, no recognition, $2K basis transfers to stock. Promissory note becomes capital asset under 453B(a), so 1223(1) tacking rule applies. 453B(a) mandates immediate recognition of gain or loss on disposition of installment obligations because while E would have the 351 nonrecognition allowance because the corp only gave him a promissory note in exchange for the property, he turned around and sold it for hard cash.

(b) Distributtee computations

Formalistic answer – corp didn’t contribute anything (the stock cost nothing, so they contributed zilch to each transfer), so they realize full $100K of all transactions. But basis carries over with corresponding transactions in 358(a), and tacking applies with 1223(2).

A – complete nonrecognition
B – Must recognize $5K gain when inventory is sold
C – May recognize $5K loss on sale of land
D – Must recognize $20K gain if equipment is sold.
E -

(c) Double tax. Justification? The transfer created new wealth of $10K, kind of like a successful double down.
2. Requirements of nonrecognition of gain or loss under 351

A. “Control” immediately after the exchange 351(a)

351 only applies if the transferors as a group “control” the corporation immediately after the exchange. Must include direct ownership of at least 80% of all voting stock and 80% of all nonvoting stock. 368(c). 318 constructive ownership rules don’t apply.

Intermountain Lumber 48 (Tax Ct. 1976)
Shook incorporated and transferred his mill to the new corporation. As part of the incorporation plan, he agreed to sell 50% of his shares to Wilson. After the transfer, he tried to claim 351 so he’d avoid taxes as nonrecognition of gain, and Wilson tried to argue that the stock agreement was a sale so he could record a higher base and a larger deduction on higher depreciation. The court said no, that the agreement to sell 50% was a condition of the incorporation, and thus Shook had no intention of maintaining the 80% control necessary for 351 applicability. Intermountain had to record the gains and depreciate them normally.

Even an implicit, albeit non-contractual agreement, will fall under the purview of the step-transaction doctrine. Enforcement of this principle, though, is obviously problematic.

How could this have been constructed to still create a right to nonrecognition? Wilson was not a contributor, and he should have been. Had he contributed at all, both Wilson and Shook would have been transferors controlling 100% of the assets.

Options:
1. Cash contributions from both parties. Wilson contributes cash ($91K) directly to the sawmill, Shook contributes the capital assets. Unfortunately, Shook would out-contribute Wilson 2:1 ($182:$91), and the shares would more appropriately break down according to that ratio.
2. Pre-incorporation partial sale. Shook sells half interest in his sole proprietorship to Wilson (thus forming a partnership), and then incorporate it and buy the mill. Unfortunately, Shook will be immediately taxed on all of the previously unrealized appreciation when he sells the partnership interest to Wilson (only half of appreciation actually taxed because Shook only sells half the partnership). On transfer to the lumber mill, Wilson will gain a FMV basis for his contribution because of his initial cash purchase of the partnership interest being at FMV.
3. Cash boot. Shook contributes assets, Wilson contributes cash. Shook receives 182 shares of stock, $91 cash “boot” back. Wilson contributes the same amount of cash and stock received. However, this merely masks the transaction as contemporaneous corporate funneling to Shook for control.
4. Lender financing. Bank makes $91K loan to Shook. He transfers the sole (encumbered) proprietor assets to the lumber mill, Wilson contributes $91K. Both get 182 shares, respectively. The lumber mill pays off the loan. The debt transfer does not prevent 351 nonrecognition, and the “constructive boot” is ignored for tax purposes (357(a)) ONLY IF the loan is for some valid business purpose (357(b)).
5. Post-incorporation distribution. Shook transfers assets to lumber mill. Later, mill distributes $91K to shareholders (Shook) as a 301(c)(2) return of capital (not a dividend because there has been no profit in the corp yet). Wilson contributes $91K and receives 182 shares. Nonrecognition on step 1, tax free return of capital on step 2, nonrecognition in step 3, but still may run into a step-transaction doctrine problem.
6. Redemption. Initial transfer of assets from Shook ($182K FMV), $91K cash from Wilson, and corp distributes 364 shares to Shook and 182 to Wilson. Corp then redeems 182 shares outstanding from Shook for $91K.

B. Transfers of “property” and services

“Property” has been broadly construed to include cash, capital assets, inventory, AR, patents, and in certain circumstances, intangible assets like patents and process knowledge. Services can’t be
considered property for 351 treatment, only income. 351(d). If a transferor receives stock for both property and services, all of the stock can count against the 80% requirement. Stock as compensation is computed under 83(b).

C. Solely for “stock”
Stock means normal equity investment with the company.

Problems 53-5
1. Qualify under 351?
(a) Yes to A’s transaction (realized but not recognized). Corp doesn’t pay tax because of 1032. B gets hammered with both realization and recognition, even though B received all of the nonvoting stock, because B ain’t got no control.
(b) Yes – step transaction doctrine. A and B are both transferors to the corp, and control is tested on March 2 after B transfers.
(c) If control is tested post march 5, control is destroyed. D hasn’t contributed anything. But if the test is as in (b), and that is successfully argued, then the nonrecognition still stands and the “gift” is unrelated. Passes both narrow and broad interpretations of step-transaction doctrine, either because the gift was not contractually binding (narrow), or because the gift was indeed a gift and not a sale transaction in tax terms.
(d) No

2. Tax evaluations
Valuation in 61(a)(1), 83(a)
(a) No protection in 351, because Manager is offering service instead of property in exchange for stock.
(b) Yes, 351 qualification if Manager is paying for her stock. As for the second part, “Is it property?” A promissory note, if property, satisfies the control test. The total economic effect is almost exactly the same as the situation in (a), but in this case instead of receiving stock as a compensation package, Manager is essentially “discounting” her salary against a purchase payment system for the stock she would have received in the (a) scenario.
(c) No, because of the de minimis value of the property in comparison to the stock received, in what looks like a mask for service compensation. 1.351-1(a)(1)(ii). Recognize the de minimis payment as purchase of equivalent stock, then tax Manager on the remaining $149K as income. Ouch.
(d) Manager kicks in more than 10% of the value of stocks essentially allocated as “service compensation,” so the transaction is not de minimis.
(e) Restricted in-kind compensation. Amount of compensation is based on time when in-kind compensation becomes transferable or not subject to substantial risk of forfeiture. 83(a). Barring Manager’s leaving, the valuation and taxation would mature when the restrictions on her shares are lifted. Then there’s the 83(b) election to avoid the tax deferral and pay up front (possibly insurance against massive taxation later if stock value skyrockets). Pays without regard to risk of loss. Taxed as ordinary income up front. If sold, treated as market appreciation (LTCG).

What about (e) under 1.83-1(a)? “Until you pay tax, stock isn’t owned by service provider.” Control issue? If Manager 83(a) pays up front, no issue. Otherwise, for tax purposes no one would be the owner until someone paid taxes on them. but there should really be no issue at all, since there is no control dispute at all. The stock, if Manager 83(b) elects out, is basically unissued treasury stock, so effectively 100% of the corp is controlled by the remaining two parties to the incorporation.

Alternatives to accomplish the business objective and Manager’s equity stake:
Issue two classes of stock, common and preferred, with respective low and high values
Have preferred represent most of the capital considerations of the corp
Distribute preferred to the capital investors
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Distribute common (voting) at $1par, 51% to Java and the remaining 49% between Venturer and Manager. Manager now becomes capital contributor.

→ Downside? Tax flexibility – can’t elect S corp because of two classes of stock.

Alternative 2 (Silicon Valley)

One class of stock
Warrants to service providers
Distribute common to Java and Venturer, none to Manager
Give manager warrant (pull option) for future common purchases
1.351-1(a)(1) says that warrants aren’t included in term “stock or securities”, so no control issue

3. Treatment of Boot 351(b), 358(a), (b)(1); 362(a)

351 – Nonrecognition
358 – Shareholder basis rule
362 – Corporate basis rule
1032 – Corporate nonrecognition rule

A. In general

Policy: Tax all gain realized from transfer up to the amount of boot, because transferor is defeating the “changed form investment” grounds for 351 nonrecognition.

Normal Boot Rule: Recognized gain = amount of boot; basis in transferor’s stock in 358. “Return of Capital Last Rule”

Corporation basis: Transferor’s basis + transferor’s recognized gain from boot. 362.

Alternatives:

Partial sale approach: subdivide interest in property for transfer in exchange for 100% stock (step one); sell remaining interest for non-stock consideration (step two).

Example:
$100 FMV
$ 10 Basis

Contribute 80%, so basis in exchanged property is 8. Transfer covers basis, so no recognized gain on remaining realized gain (72 to corp under 351).

Sell 20% interest for $20 FMV bond. Realized gain $8 for transferor, but should be $20 (face value of bond). Corp’s basis is $20, and corp’s basis in total property ends up being 28 (transferor’s 8 basis goes to corp under 362)

$10 of bond received is taxed to transferor (other $10 recovered as original basis – 301(c))

<table>
<thead>
<tr>
<th>Results</th>
<th>Realized gain</th>
<th>Recognized gain</th>
<th>SH’s Adjusted Basis stock</th>
<th>Corp’s AB property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal boot rule 351(b)</td>
<td>90</td>
<td>20</td>
<td>10</td>
<td>30 Return of capital last</td>
</tr>
<tr>
<td>Partial 351(a) sale 1001(c) treatment</td>
<td>90</td>
<td>18</td>
<td>8</td>
<td>28 Pro rata return of capital</td>
</tr>
<tr>
<td>Contribution 351(a)/distribution 301(c) treatment</td>
<td>90</td>
<td>10 (LTCG)</td>
<td>0</td>
<td>N/A Return of capital first</td>
</tr>
</tbody>
</table>

There is no boot rule for partnership organization (721(a)), so courts apply partial sale treatment because of the literal substance of the transaction.
“Other property” not stock that is given by a corporation in exchange for transferred property. 351(b) requires transferor receiving boot to recognize any realized gain on the transaction to the extent of the money or FMV of any nonqualifying property received. Requires recognition of gain before basis can be recovered, so that boot cannot be abused.

When multiple items are transferred, each one is treated as a separate transaction.

Example:
$200K property with $20K basis transferred to corp for $170K stock and $30K cash. There is still a $180 realization, but only required to recognize that gain to the extent of the boot received. So transferor recognized $30K immediately, but doesn’t mess with the remaining $150 until the stock is sold or converted into another, corporately unrelated asset. The basis is then fully recovered from the $30K of boot (with a tax on the remaining $10K after the basis deduction), and the rest of the FMV is deferred to encourage corporate investment.

B. Timing of 351(b) gain
Debt instruments of the corporation exchanged to the transferor in return for the capital contribution do not qualify for 351 nonrecognition, but they aren’t fully recognized immediately. They are treated as installment payments under 453.

The transferor’s basis is first set off against the stock (non-boot exchange item) up to FMV. If the basis doesn’t exceed the FMV, then there is no immediate charge. If it does, then the excess basis is allocated to the installment portion of the transfer. 453 is then applied against the installment portion of the contract. If there is any remaining basis, it offsets the face value of the obligation.

Note: gain from inventory property exchanged for a note is a SALE, and must be recognized immediately.

Example:

Problem 63
A gives $22k FMV inventory ($15K basis); gets 15 common ($15K), $2K cash, 100 preferred ($5K)
B gives $20K FMV inventory ($7K basis), $10K FMV land ($25K basis); gets 15 common ($15K), $15K cash
C gives $50K FMV land ($20K basis); gets 10 common ($10K), $5K cash, corp not for $35K/two years

Tax consequences (gain or loss realized and recognized, basis and holding period)?

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Equipment</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV</td>
<td>$22K</td>
<td>$22K</td>
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<tr>
<td>FMV c. st.</td>
<td>$15K</td>
<td>$15K</td>
</tr>
<tr>
<td>FMV p. st.</td>
<td>$5K</td>
<td>$5K</td>
</tr>
<tr>
<td>Cash</td>
<td>$2K</td>
<td>$2K</td>
</tr>
<tr>
<td>Realized</td>
<td>$22K</td>
<td>$22K</td>
</tr>
<tr>
<td>Adj. basis</td>
<td>$15K</td>
<td></td>
</tr>
<tr>
<td>Gain/loss</td>
<td>$7K</td>
<td></td>
</tr>
<tr>
<td>Carryover basis</td>
<td>$5K</td>
<td>(AB in stock for future recognition)</td>
</tr>
<tr>
<td>Recognized</td>
<td>$0</td>
<td>($7K basis – $7K boot recognition)</td>
</tr>
</tbody>
</table>

Corp
AB equip. $15K (362(a) carryover basis from transferor)
Corporate Taxation Outline

+ 2K
$17K  
(Cash payment)

(Corp basis in property - $5K in appreciation recapture for future recognition)

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Inventory</th>
<th>Land</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV</td>
<td>$30K</td>
<td>$20K</td>
<td>$10K</td>
</tr>
<tr>
<td>%</td>
<td></td>
<td>66.7%</td>
<td>33.3%</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>FMV stock</th>
<th>Cash</th>
<th>Realized</th>
<th>Adj. basis</th>
<th>Gain/loss</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$15K</td>
<td>$15K</td>
<td>$30K</td>
<td>$7K</td>
<td>$13K</td>
</tr>
<tr>
<td></td>
<td>$10K</td>
<td>$10K</td>
<td>$20K</td>
<td>$7K</td>
<td>($15K)</td>
</tr>
<tr>
<td></td>
<td>$5K</td>
<td>$5K</td>
<td>$10K</td>
<td>$25K</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Carryover basis</th>
<th>Recognized</th>
<th>– OR –</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>($2K)</td>
<td>$0</td>
<td>($13K basis – ($15K) boot recognition)</td>
</tr>
<tr>
<td></td>
<td>$13K</td>
<td>$13</td>
<td>($13K basis – 0 (no recognition of loss))</td>
</tr>
</tbody>
</table>

Associated basis for stock:

$7K Inventory
+$25K Land
+$10K Recognized gain
– $15K Cash boot
$27K Basis in stock

$15K Stock value
$27K Basis
–12K

Corp

AB inv.  $7K  
+$10K  
$17K  
(362(a) carryover basis from transferor)

(Cash payment)

(Corp basis in property)

AB land.  $25K  
+$0K  
$25K  
(362(a) carryover basis from transferor)

(Only increase basis by boot on transferred property that generated the recognized gain for transferor – already added to inventory, supra)

$25K  
(Corp basis in land)

P.S. While only a portion of this stock qualifies for the tacking period, the tacking period may be applied to all shares pro rata (the same 2/3:1/3 ratio).

C

Transferred:

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Recognized gain</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$50K</td>
<td>$30K</td>
</tr>
<tr>
<td></td>
<td>(FMV; $20 basis)</td>
<td>(FMV – basis)</td>
</tr>
</tbody>
</table>

Received:

<table>
<thead>
<tr>
<th></th>
<th>Common</th>
<th>Cash</th>
<th>Note</th>
<th>Total boot</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$10K</td>
<td>$5K</td>
<td>$35K</td>
<td>$40K</td>
</tr>
<tr>
<td></td>
<td>(Two year note)</td>
<td>(Note + cash received)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Qualify for 453(a) installment payment option? Large portion of boot is installment note, and any receipt of promise to pay later for transferred goods qualifies for 453(a).

How does basis get applied? Assign it first to stock (nonrecognition property) up to FMV, then remainder (if any) to boot.

AB stock $10K (FMV fully covered by basis)
AB boot $10K ($40K total payments, so ¼ each payment treated as basis, ¾ each payment treated as gain)

→ Works out to taxable amount on $5k = 3,752, on $40K note = $26,250.

Corp AB land. $20K (362(a) carryover basis from transferor)
+ $3.752K (Recognize gain only when transferor recognizes gain from payments)
$K (Corp basis in land)

What if C had given $50K FMV non-capital assets? C wouldn’t qualify for 453(a) installment treatment, and the $30K gain would all be taxable up front. What about recapture when there is an installment note? 453(i), overriding 453(a) through 1245(a), says that any non-capital asset recapture income will be recognized according to the payouts, i.e. exactly like the installment option.

4. Assumption of liabilities 357, 358(d)

357 – Corporate assumption of liability
358 – Basis to distributes (shareholder basis rule)

1031/1031(d) – Like-kind exchanges: “...such assumption [of taxpayer liability] shall be considered as money received by the taxpayer [and subject to tax immediately].”

Carve out:
357(a) – Whoa, wait! Liabilities aren’t boot for purposes of immediate recognition, so you aren’t taxed up front. So, to make up for this exception, 358(d) comps by reducing basis.

Most corp formations involve corp assumption of debt, which is normally considered boot for the transferor. But applying that strictly to corp formations would frustrate 351. So 357 makes an exception, and 358(d) comps for that immediate taxable loss by adjusting the transferor’s basis down in the encumbered property. If the diminution of basis through 357(a) would result in a negative basis, then the transferor is required to recognize that negative amount as a gain at the time of transfer. 357(c).

Lessinger 68 (2nd 1989)
Avoiding the “357(c)” trap. Lessinger contributed assets of his sole proprietorship to his corporation, but the SP was insolvent and $200K in the red. He also contributed a note to the SP (basically a scribble, an accounting entry that was scribbled into the ledger by Lessinger’s accountant (and possibly while Lessinger was unawares)) with a face value of essentially that same negative amount to the SP, which was also transferred. Lessinger avoided the negative basis 357(c) trap requiring negative basis gains recognized on straight transfer of property. IRS balked. Court extrapolated their holding from a broad reading of 357(c) and 362 together. Crux is “legally enforceable obligation to contribute money in the future.”

→ Also, if Lessinger wasn’t allowed to contribute the note and the SP was in the red when it was transferred, he runs into the Fraudulent Conveyances Act. Ouch.

Should that legally enforceable obligation to pay cash in the future represent a cash payment now? Court doesn’t really answer it, but seems to indicate that they’d say “yes.”
Peracchi (9th 1998)
Alternatively to Lessinger, Peracchi was allowed to claim basis in his personal promissory note to his corporation (a legitimate note, different than the Lessinger scribble [also the name of a new dance]). Court reasoned that the note would be enforceable in bankruptcy, so there must be some basis because of Peracchi’s increased exposure to risk in pledging the note. Therefore, he’s entitled to an upped basis to the extent of his possible exposure to loss should the corp tank. The court limited this allowance to notes worth approximately their face amount.

Note: You should always be able to beat this IRS argument by borrowing the money first, and then pledging it in full to the corp. Some semblance of real liability goes a looong way to making this “basis-up” strategy legitimate.

Æ

The real issue in both of these cases: TIMING. Not if you get a basis increase, but when the basis increase should occur. Since this is a debt in both cases, should it be installment method recognition???

Problems 80
1. A contributes: Inv, $10K FMV ($20K basis); land, $40K FMV ($20K basis, $30K mortgage).
   A receives: 20 shares ($20K value), corp assumes mortgage.
   a) $20K AB Inventory
      + $20K AB Land
      – $30K Liability transferred (from 358(d))
      $10K Basis in stock
   Assuming that A isn’t a realtor, the holding period of the land transferred will be tacked pro rata across all of the stock received. There is no holding period tacking for the inventory, as it isn’t a capital asset.

   Corp basis will be $20K.

   b-d) Liabilities will be in excess of basis, so there will be a $5K recognized gain (357(c)). Will end up with $0 basis:
   $25K AB basis both inv and land
   + $5K Recognized gain
   – $30K Liability
   $ 0 Basis

   Corp basis will be transferred basis, but 1.357-2(b) says prorate the basis across the gross value of all contributed assets.

Æ

Wiedenbeck thinks that the allocation should be recognized according to the appreciation in value of the respective items, not according to gross FMV as proscribed in 1.357-2(b).

Æ

2. B contributes: Building, $400K FMV ($100K basis), with first mortgage of $80K (valid business) and second mortgage of $10K (personal, eve of transfer).
   B receives: $310K stock, assumption of liabilities.
   a) B gets hammered by 357(b), because a tax avoidance purpose combines total liability assumed (avoidance AND valid business purpose), and treats the final number as cash boot.

   b) Policy: Don’t fuck around with 35’s graciousness. We’ll wallop you with recognition immediately.

3. 
Corporate Taxation Outline

5. Incorporation of a going business

Hempt Brothers, Inc. 81 (3rd 1974)

Assignment of income. AR may be considered property for tax computation purposes ONLY WHEN it serves the policy of 351. Accounts receivable are transferable, but the AR in this case were generated form services. The service provider is always the entity taxed, no matter where the AR goes. Since 351 property can’t be services (351(d)), then there is a conflict that must be resolved in light of the congressional purpose of 351 (look for hidden payment for services, etc., schemes to use

⇒ Exam tip: Always look for step transactions, alternative solutions, etc., when analyzing cases.

Liabilities under 357(c)(3)

482 Reallocation
If you have multiple related business, there may be a reallocation issue. Service has discretionary ability to reallocate tax burden. The Service will look for evidence of improper reallocation of amounts to mismatch income and split tax consequences.

Revenue Ruling 95–47
Where liabilities give rise to a capital expenditure. Transfer of environmental liability. Corp contributed land that was encumbered by environmental liabilities. Potential application of 357(c). to the extent that the liabilities would be considered “ordinary repairs to land and equipment,” the costs would qualify. But the extraordinary nature of these cleanup costs are too high, and must be considered capital expenditures, which are specifically eliminated from 357 exception qualification.

Problem 90
a)
b) Design.
c) Yes.
d) e)
f)

6. Collateral issues

A. Contributions to capital 118(a); 362(a)(2), (c)
When a shareholder transfers property other than cash without receiving anything in return, they have made a contribution to capital and can increase their basis in already held stock to reflect the transfer. The transferred amount is excludable as gross income by the corp. Transferor’s basis carries.

Fink 92 (1987)
Non pro-rata surrender of stock to capital. Not only did Fink want to take an AB deduction on the surrendered and cancelled shares, but they also wanted to claim it as a 165(f) ordinary loss. They claim that yes, the stock was a capital asset, but the loss was not incurred through a sale or exchange. It was a surrender, so it eschews the capital gains/losses requirements of 1223. Congress remedies this with 1224A. But the real issue in front of US was was there realized loss? IRS says no, because they were still majority shareholders post-contribution. Service says they should have upped their basis in the remaining stock by the basis of the amount of the stock surrendered. US agreed.

⇒ Ways around: Have the corp buy shares from shareholders outright, then shareholders take the proceeds form sale and contribute those to the corp as a direct contribution to capital. No net change in assets, but the contribution then becomes a real contribution to capital.

302 would have helped this definition
Corporate Taxation Outline

B. Intentional avoidance of 351

C. Organizational expenses

Problem 100

B. Capitalization

1. Introduction
   What difference does it make if investors hold stock, bonds, or notes? Tax treats debt and equity differently, and the more favorable tax treatment is with debt. Issuing debt avoids the double tax; repayment of debt is tax free on principal and capital gains for excess difference, where stock buybacks (essentially debt repayment to the shareholder) may be taxed as dividends if the shareholder retains some stock. See also the 351 stock/boot differences in tax recognition.

2. Debt v. equity
   Problem – Deductions for interest, not for dividends
   Incentives –
   Policy – Substance v. Form

   Case 1: GM Stock
   GM Bonds  Shareholder owns 0.000001% GM common, some bonds – so no real conflict.

   Case 2: Closely held corp
   A  B  C
   60 sh 30 sh 10 sh  Different levels of ownership will create equilibrium
   30 bonds 10 bonds 60 bonds  for fair distribution of corp wealth among both shares
   and debt.
   X corp

   Case 3: Priority bonds over subordinate outside lender claims. What incentive is there for the bondholders to act as proper creditors?

   The IRS can analyze substance over form to determine whether corporate obligations are debt or equity. There is a spectrum in case law that may help, with one end being equity (risk investment with the potential of shared profits) and the other being debt (fixed promise from corp to repay principal with interest at a fixed maturity date). Then there are all the spots in the middle, left to the courts to decide where a particular investment falls. Some say that the disparate results in the courts have created a “smell test” for either debt or equity. The principal factors of the smell test are:

   - Form of the obligation – While labels aren’t controlling, a proper label may ward off a challenge that debt is actually equity.
   - The debt/equity ratio – Ratio of company’s liabilities/shareholder’s equity. The more thin the capitalization, the better ammo for the Service to classify an item as equity under the rationale that no lender in their right mind would loan out to a severely undercapitalized business. However, the bar of what is and isn’t thin capitalization has been amorphous in the case law.
   - Intent – Gleaned by an objective look at criteria such as lender’s reasonable expectation of repayment in light of the company’s financial condition, and the corp’s ability to pay the principal and interest.
   - Proportionality – In closely held corps, debt held by the shareholder in the same proportion as stock raises eyebrows with the Service. If close to equally leveraged, by what incentive would the shareholder/debt holder enforce his/her own debt?
     o “Stock overlap”: Assume that stock ownership and debt holdings are proportionally equal among investors. Treasury says compare % stock owned and % of instrument in question. If the lowest comparison from each investor added together tops 50%, then the
Corporate Taxation Outline

A debt instrument will be considered equity (i.e., one shareholder’s relative stock is 20%, another’s relative debt holdings are 31%, combined >50%, then debt = equity)

- Subordination – Frequently, outside creditors require that shareholder debt be subordinated to their claims.

**Hybrid instruments**

The big banks have tried to eschew a one-or-the-other classification by issuing products with massive hybrid characteristics that they claim allow for interest deductions while allowing for equity treatment on balance sheets. The Service has made announcements indicating that it will pursue disputes on such hybrids that have unreasonably long maturity dates or the ability to repay principal with corporate stock. Anyway, this is still a gray area. But 385(a) was amended to add a parenthetical that allows the Service to treat hybrids as scrambled transactions – in part stock, and in part indebtedness.

➔ In tax advising, do everything to avoid hybrids if there is concern about debt v. equity. Also make sure capitalization of corp isn’t too thin, that client adheres to the terms of the debt instrument, and that strict proportionality is avoided.

3. **The Section 385 saga**

To prevent tax avoidance through the use of excessive debt, 385 allows the Treasury to create regs on determining whether an interest in a corp is stock or debt in substance, regardless of how the corps label it. 385(b) sets out factors to be taken into account when determining whether a debtor-creditor relationship exists:

- Form
- Subordination (shareholder debt equal to or higher than outside lenders)
- Debt/equity ratio
- Convertibility
- Proportionality

The 385(c) obligation of consistency locks the issuer’s characterization of the interest at the time of issuance, but doesn’t restrict the Service from the reclassification endeavor listed above. The rule only applies to the issuers; it doesn’t apply to the holders and how they apply the interests to their taxes.

**Problems 123**

1. A, B, and C form Chez. A contributes: $80K cash; B contributes: building, $80K FMV ($20K basis); C contributes: $40K cash, $40K goodwill. Each receives 100 shares Chez common. Chez requires $1.8M additional capital. Goodwill Bank loans $900K at two points over prime for mortgage on renovated building.

   Look to flowchart for aid in D:E question

   a) Assume A, B, and C will contribute the remaining $900K equally in the form of $300K, 5-year notes at variable rate of prime –1%. Passes 385(b)(1) because there is a fixed determination of debt, fixed time. But proportionality is 100%, and the outside D:E is 1.8M:240K, or 7.5:1 (and 12.9:1 if you use AB for equity). The inside D:E is 900K:240K, or 3.75:1 FMV (6.4:1 AB). So this doesn’t pass safe harbor, but it’s not necessarily considered debt. You’d have to make a case that it wasn’t (i.e., numbers for safe harbor are close, another party would possible have made the same kind of loan, etc.). But could this really pass when considering the commercially inadequate interest rate?

   b) Assume (a), but that the note is a 10%, 20 year debenture payable only out of net profit. Difference from above is that this is a hybrid, and then the instrument loses one of its only positive aspects in the “it’s debt” argument.

   c) Same as (a), but the investors will personally guarantee the Bank’s loan (which is now unsecured). Should this be treated as the bank loaning $300K to each shareholder, and thus reduce Chez’s D:E?

   Under this two step characterization, would this then be considered a shareholder’s contribution to capital? What about when Chez would attempt to deduct an interest payment to Bank? Chez would have to distribute the interest in the form of a dividend to the shareholders, who would then pay the bank as interest on a personal loan and deduct it themselves. So shareholders wouldn’t care because there’s no tax repercussion. Well, as mentioned above, the D:E is substantially lowered. But in this
characterization, the contribution to capital becomes true equity because the loan to Chez would not have been made but for the shareholder’s guarantee.

d) Assume that A will loan the entire $900K with the same terms as (a). Becomes straight debt, because there is no proportionality. Unless, of course, A is related to either B or C.

e) Debt in form as an unconditional obligation. Chez stops paying interest, so if A doesn’t sue for payments, then there was probably no intention to treat the debt instrument in question as true debt. May be reclassified as equity if there is failure to perform corporate obligations.

4. **Character of loss on corporate investment**

If you need to see policy considerations or a narrative guide to 1244 for recharacterizing loss for small business shareholders, look in CB 131-33.

165 - losses

Debt – worthless securities 165(g) Also consider 165(j), 163(f) (registration required unless v. bad debt business (ordinary income deduction) 166 1) term < one year, or v. non-business (capital loss deduction) 166 Generes 2) privately placed loans) 301(c) – 1. mandatory d

C. **Operating (Nonliquidating) Distributions**

243(a), (b)(1); 301(a), (c); 316(a); 317(a).

Regs: 1.301-1(c); 1.316-1(a)(1)-(2).

1. **Earnings and profits**

Function: Distinguish distribution properly subject to double tax from return of shareholder invested capital.

Concept: Cumulative undistributed after-tax earnings.

Capital assets merely change of form – do not increase corp’s net assets until the changed asset gains interest.

Earnings and Profits (E&P): Assets – liabilities – SH capital contributions = RE

→ Technical definition in 312.

ii. Start with corporate TI [corp’s ordinary method of accounting; tax law realization and recognition laws govern]

iii. Adjustments for:

- Tax-free income
- Nondeductible current expenses (162, bribes, lobbying expenses, fines, etc.) and losses (related party losses 267(a), etc.)
- Timing adjustments
  
  Depreciation – ACRS (312(k)(3))
  
  Installment sales (312(n)(5); 453)

316(a) – defines a dividend as any distribution of property made by a corporation to its shareholders out of (1) earnings accumulated after Feb. 28, 1913 (“accumulated earnings and profits”), or (2) earnings and profits of the current taxable year.

→ Makes two irrebuttable presumptions: (1) every distribution is made out of earnings and profits to the extent that they exist, and (2) every distribution is deemed to be made out of the most recently accumulated earnings and profits.

In testing for dividend status, look at the earnings and profits at the close of the taxable year in which the distribution was made. Any dividend out of current earnings and profits is taxable, regardless of historical deficits.
Problem 140

Gross profits from sales $20K
Dividends received from IBM 5K
LTCG 2.5K
Total gross income $27.5K

Deductions
Salaries – 10.25K
Dividends received (70%) – 3.5K
LTCL sale – 2.5K (limited by 1211)
Depreciation – 2.8K
Total $ 8.45K

Adjustments:
Tax exempt interest $ 3K
Dividends received deduction 3.5K (not allowed in computing earnings and profits; only in computing tax liability)
Excessive depreciation 1.8K
Total $ 8.3K

Decreases:
Excess of LTCL sale $ 2.5K
Estimated taxes .8K
Total $ 3.3K

Total A&D $ 8.45K
Total $13.45K

2. Distributions of cash
301(a), (b), (c); 312(a); 316(a). Regs 1.301-1(a), (b); 1.316-2(a)-(c).
Distribution is amount shareholder receives. Every distribution is a dividend to the extent of current E&P. Distribution above P&E reduces shareholder’s basis. If basis is fully reduced, then remainder is computed as gain from sale or exchange.

Note: cash distributions are capable even if accumulated E&P has been reduced to zero. Any appreciated asset that has collateral value can be borrowed against to provide a cash distribution, while not being reported on the annual E&P computation.

Problem 144

a. ... and E&P is reduced to zero according to 312(a) ($17.5 reduced to the extend of Pelican’s available $5K in E&P – 312(a) cannot force a negative E&P)
b. All $10K is a dividend, regardless of the fact that there’s an accumulated dividend. Every distribution comes first out of current E&P. 316.
c. Allocate all year-end E&P pro rata to all distributions made during current year (2 distributions, $2K per). 316. Now apply pro rata to accumulated E&P (316 “or”), wiping out the remaining $8K of the first distribution (accumulated E&P not prorated over all distributions like current E&P) and leaving $2K to split between the last distribution (half goes to each). Leaves $1K accumulated E&P per shareholder, and combined with the $2K current E&P results in $3K left over. This remainder is applied to reduce the shareholder’s AB.
d. $7.5K dividend because the current loss is offset by historical E&P. Assuming that current E&P declines steadily during the current year, $10K/4 (distribution on ¼ year) = $2.5K.

1.316-2(b) current E&P deficit (see p. 1274) – If there is a deficit in the E&P, you can assume steady decline as year goes along, unless corp can show specific items that caused the E&P loss. If so, then E&P can be allocated in real-time according to the events that caused the operating loss.
Corporate Taxation Outline

3. **Distributions of property**
   General Utilities doctrine: 311(a). Distribution in kind allowed corp to distribute appreciated property to shareholders to avoid corp-level tax on sale. SH would then sell and not realize gain because of 301(d) FMV basis rule. Congress figured it out and basically (with limitations) repealed doctrine in 311(b).

   **Problem 148**
   a. Current E&P goes up $9K on realization of FMV distribution. 311. Gain is taxed, which reduces E&P. Net consequence is $6K (assuming 1/3 tax) increase in current E&P. SH receives FMV basis in property received. 301(d). Distribution becomes dividend to extent of E&P (both accumulated and current),
   b. First, corporate tax consequences. $9K gain. 311(b). Corp level E&P rises to remaining level after corp gain tax. Step 2: SH consequences. Amount of distribution = FMV – property’s associated liabilities. 301(b)(2). $20K - $16K = $4K distribution. Corp current earnings (in this case, at least the newly realized $6K) covers, so all $4K is a dividend. 312 (a), (b). The result is corp E&P increase of $2K ($6K remaining from initial gain – $4K dividend = $2K). SH basis = FMV, regardless of the encumbrance (the inherited debt will equal a deduction on interest for the recipient). Scott Szcorczik is Ralph Wiggum.
   d. Assume AB land = $30K. If corp simply distributes land, the it will realized loss of $10K (301(b) says FMV is used to calculate loss). E&P gets hit at full AB, so with $25K accumulated and $15K current E&P – $30K, result is $10K rolled over into accumulated E&P next year. 312(a)(3). Corp should have sold the land and then distributed the profits.
   e. 1016(a)(2) – depreciation as a deduction.

4. **Distributions of a corporation’s own obligations**
   311(a), (b)(1); 312(a)(2). Reg 1.301-1(d)(1)(ii)
   Gain recognition rule doesn’t apply to distributions for corp’s own debt obligations. Normally, E&P is reduced by the principal amount of the obligation attributable to that year. But in cases where there is a lower current value on the debt obligation that face value, a corp could evade earnings tax by eliminating book earnings with issuance of a facially overvalued debt obligation, skipping the earnings tax in favor of the lesser dividend tax. In the case of an obligation with an original issue discount, then corp can only reduce by that discounted amount.

   **Problem 151**
   312(a)(2). Somewhere in here there’s a $5K return of capital. Corp can lower E&P $5K (current discounted value of the debt obligation), and then reduces corp assets $100K (wiping out all E&P and paying out $5K of capital assets). Equals net of $5K dividend. Plus, recipient will owe taxes on interest income (since the note will pay $100K and he bought it for $5K, there will be essentially $95K in interest accumulated over the life of the obligation).

5. **Constructive distributions**
   Reg 1.301-1(j)
   High rent, family salaries, etc. are tools corps use to avoid dividends – which they aren’t able to deduct. Rest assured, the IRS will hunt these things out, smoke them out of their caves, and get them running. See Nicholls (Tax Court 1971) (constructive dividend for personal use of corporate yacht – dividend to mom and dad, gift from them to son. What about calling it constructive compensation to James the sailor?). See also 482, Revenue Ruling (considering two fully controlled corps, where one sells the other an item at a gross undervalue, allowing the other to avoid E&P increases and higher corp income tax).

6. **Anti-avoidance limitations on the dividends received deduction (DRD)**
   243(a)(1), (3), (b)(1), (c); 246(a)(1), (b), (c); 246A; 1059(a), (b), (c), (d), (e)(1)
   Corporate shareholders (corps, for godsakes) receive a deduction on dividends to corporations to avoid triple taxation. 243 deductions:
   General: 70%;
Corporate Taxation Outline

If recipient corp owns > 20% of distributing corp: 80%;
If both corps are controlled under an umbrella elected affiliation group: 100%.

246(c) holding provisions: What of a corp buys stock immediately pre-dividend at stock + dividend price, receives the dividend, then sells the stock post for its face value? Corp could record dividend as income (at 30%), and then claim the reduced sale price as a STCL to use the “loss” on the difference between their purchase and sale price to offset other income elsewhere.

7. Use of dividends in bootstrap sales

TSN Liquidating Corp. 163 (5th 1980)
Note: A valid business purpose will prevent the dividend technique used in this case from becoming the dreaded “sham transaction.”

D. Redemptions and Partial Liquidations
302, 317(b)
302(a) sale treatment: if you fall into one of the four categories of (b), you get sale treatment (and LTCG/LTCL tax treatment). If you don’t fall in (b), then you go to (d) and are treated as a dividend.

Example: Alpha Corp, 100 shares: X, 60; Y, 20; Z, 20.
If Y sells its shares to Alpha, then (b)(3) applies. Gets sale treatment, but in actuality the transaction is not like a real sale because (decreases corp value through the distribution of capital assets, increases X & Z’s ownership percentages).

What if X sells 15 to the corp? Reduces outstanding shares to 85, but X still maintains control of majority shares. Still dividend treatment, even though there is different effect (no uniform dividend distribution, ownership percentages and ROI entitlement altered, etc.). Normal dividend wouldn’t do that.

Assume complete redemption of Y. X percentage ownership increases to 75% (60/80); Z to 25% (20/80). If there was a straight distribution of 20% of Alpha’s worth, then X would receive 12% of that amount; Y, 4%; and Z, 4%. But as this example goes, 20% is going to Y alone.

Wiedenbeck thinks that every redemption is in part a redemption and in part a sale because of the diluted positive effects for remaining shareholders. Constructive dividend occurs to those shareholders who are not actively participating in the transaction.

1. Constructive ownership of stock
302(c)(1), 318 (Constructive ownership)
Four categories of “attribution” rules (when close party’s stock ownership is attributable to the shareholder and transaction in question)

i. Family attribution
An individual is considered as owning stock held by spouse, children, grandchildren, and parents. In-laws don’t count. No attribution from a grandparent to a grandchild.

ii. Entity to beneficiary attribution
Stock owned by or for a partnership or estate is considered as owned by the partners or beneficiaries in proportion to their beneficial interests.

iii. Beneficiary to entity attribution
Stock owned by partners or beneficiaries of an estate is considered as owned by the partnership or estate. All stock owned by a trust beneficiary is attributed to the trust except where the beneficiary’s interest is “remote” and “contingent.”

iv. Option attribution
A person holding an option to buy stock is considered as owning that stock. Takes precedence over family attribution if both apply.
Corporate Taxation Outline

Problems 182

i. Wham, 100 shares: Grandfather, 25; Mother, 20; Daughter, 15; Adopted Son, 10 (Mother option on five); Grandmother’s Estate, 30 (Mother 50% beneficiary). Apply 318 and determine ownership amounts for:
   - Grandfather: 85 (all – 15 from remaining 50% interest in Estate [(a)(2)(a), (a)(5)(a) two-step attribution authority])
   - Daughter: 55 (15 + Mother’s 20 + Mother’s option 5 + Mother’s Estate interest 15)

ii. Xerxes, 100 shares: Owned by Partnership in which A, B, C, D all equal partners. A’s wife W owns all 100 Yancy Corp.
   a. How many, if any, of Xerxes owned by A, W, and M (W’s mother)?
      i. A, 25; W, 25; M, 0 (no family double attribution [(a)(5)(B)]).
   b. How many, if any, of Xerxes owned by Yancy?
      i. 25 [(a)(3)(C) B2E attribution + (a)(1) family attribution; double attribution not prohibited because not a double-family construction]
      ii. What if W only owned 10% of Yancy? Even for purposes of triggering the 50% threshold of (a)(2)(C) E2B and (a)(3)(C) B2E, constructive ownership ties are still applied.
   c. How many, if any, of Yancy are owned by Partnership, B, C, D, and Xerxes?
      i. 100 [((a)(1) spouse + (a)(3)(A) B2E Yancy) = A constructively owning 100 Yancy + (a)(3)(C) B2E Partnership to Xerxes 50% threshold = Xerxes ownership of all Yancy]

2. Redemptions tested at the shareholder level

A. Substantially disproportionate redemptions
   302(b)(2); Reg 1.302-3.
   If a shareholder’s reduction in voting stock as a result of a redemption satisfies three mechanical requirements, the redemption will be treated as an exchange (and not the dreaded dividend). To qualify as “substantially disproportionate,” a redemption must satisfy the following requirements:
   i. Immediately after the transaction, the shareholder must own (actually and constructively) less than 50% of the total combined power of all voting stock,
   ii. The percentage of total outstanding voting stock owned by the shareholder immediately after the redemption must be less than 80% of the total voting stock owned by the shareholder immediately before redemption, and
   iii. The shareholder’s percentage ownership of common stock after the redemption also must be less than 805 of the common stock owned before the redemption. If there is more than one class of common, then the 80% test is applied by reference to FMV.
   Attribution rules apply to these tests.

Revenue Ruling 85-14
Step transactions masking dividends as exchanges. What if a majority shareholder X exchanged shares qualified under 302(b) as making X a minority, on the knowledge that the corp would be redeeming another shareholder’s shares in the near future, thus making X the majority again? See (b)(2)(D) for recognition of this ruling, making focus entirety of facts for determination of 302(b)(2) treatment or not.

Problems 186

1. Y Corp, 100 common, 200 NV preferred; Alice, 80 common, 100 preferred; Cathy, 20 common, 100 preferred. Determine if 302(b)(2) applies?
   a. Y redeems 75 of Alice’s preferred
   b. Same as (a), except Y also redeems 60 of Alice’s common.
Corporate Taxation Outline

i. Fails (b)(2)(B), must be < 50% voting power after redemption to qualify. Cathy still has 20 shares, so they’re split 50/50.

c. Same as (a), except Y also redeems 70 of Alice’s common.
   i. Passes (b)(2)(B), but in this case the preferred stock may be qualified for 302 treatment provided that the preferred stock is not 306 “tainted” stock. See §1.302-3(a).

d. What difference would it make in (c) if on Dec. 1 of same year Y redeems 10 of Cathy’s common?
   i. Only if Alice knew that Cathy’s shares would be redeemed. (b)(2)(D). But the statutory step transaction may not apply in any case (knowledge or not), because 80% rule is the test in the statutory definition of substantial disproportionality – not 50%. (b)(2)(C). IRS would counter that step-transaction always applies, whether or not Congress reminds us of it in one particular section or not.

2. Z Corp, 100 V common, 200 NV common, $100 FMV each; Don, 60 V common, 100 NV common. Jerry, 40 V common, 100 NV common. If Z redeems 30 of Don’s V common, will redemption qualify?

No.

B. Complete termination of a shareholder’s interest

302(b)(3), (c)(2)
Utility:
- Redemption of only nonvoting stock
- Waiver of family attribution – (c)(2)
- Redemption of 306 “tainted” stock
Why is there a waiver of family attribution only?

i. Waiver of family attribution
Attribution laws pose serious harm to closely held corps. If a parent cuts the corporate cord and control goes to a child, etc., the parent would still be considered “in control” because of attribution. 302(c)(2) provides a safe harbor from family attribution provided the following criteria are met:
- Immediately post, the distributee has no interest in the corp other than as a creditor,
- The distributee does not reacquire interest within 10 years, and
- If the distributee attempts to files I dunno...read the statute to figure this one out.
Further, 302(c)(2)(B) provides that family attribution can’t be waived if, in the 10 years prior, either
- The redeemed shareholder acquired any of the redeemed stock from a “Section 318” relative, or
- Any such close relative acquired stock from the redeemed shareholder.

Revenue Ruling 77-293 exception: Neither of these exceptions applies if tax avoidance was not one of the principal purposes of the transfer.
⇒ Still: Always look for step transactions!

Policy? If you are really cutting ties, then a redemption and gift of operating assets is close enough to a liquidation that real liquidation is not necessary to show that control has been relinquished – provided that there is an affirmative showing that ties ARE cut by the distributee.

Lynch 188 (9th Cir. 1986)
If Lynch didn’t qualify for the 302(c)(2) waiver of attribution, he would have been fully taxed on the redemption because of his residual constructive ownership of the entire corporation by and through his son’s actual ownership of 100% interest in Lynch Corp. Given the statutory silence on definition of “employee,” look to common law (in this case, torts). IRS says it doesn’t care, the (c)(2)(A)(i) list is not exclusive to simply directors or executives – it applies to all employees nonexclusively.

Alternative bases for similar holding:
Corporate Taxation Outline

- Debt:equity ratio – Father constructively owned son’s shares, and father was sole owner of promissory note. Double coverage, and IRS would have called the note in essence preferred stock. Pledge of son’s shares – See §1.302-4(d), (e). The pledge of stock was OK, but enforcing the pledge (foreclosure on the stock) would be problematic for father.

- 302(c)(2)(B)(ii) 10-year look-back rule and Revenue Ruling 77-293 no-tax-avoidance rule.

Revenue Ruling 59-119
First prospect –
Second prospect – Focus on waiver and interest requirement – “no interest including” language again at forefront.
Third prospect – Unchecked discretionary veto power on extraordinary corporate policy. Bad!
Fourth – (c)(2)(B) look-back and how broadly should the tax avoidance exception be read?

ii. Waiver of attribution by entities
What if the redeemed shareholder is a trust, estate, or other entity that completely terminates its actual interest in the corp, but continues to own shares attributed to a beneficiary to the entity? Waiver of attribution is still possible, but only if the beneficiaries waive attribution and comply with the 302(c)(2) restrictions as well.

C. Redemptions not essentially equivalent to a dividend
302(b)(1), Reg 1.302-2

Davis 204 (1970)
Davis bought stock from his company so that the company could secure a loan, with the intention to redeem the stock once the loan was paid off. He bought in 1945 at $25/share and the corp redeemed in the 1960s for the same price. He claimed the transaction for sale treatment as a return of capital, but the IRS balked. CA9 held for Davis, US reversed. Davis had claimed that the stock plan was for a valid business purpose, and therefore wasn’t a dividend (which is simply a RE distribution or return of capital). US didn’t buy it, saying that the business purpose test is irrelevant in determining dividend status. They reasoned that 302(b)(1)’s “not equivalent to dividends” rule meant just that: since Davis never lost or changed in form any control of the closely held corp, the redemption was like a dividend. In order to qualify as not essentially equivalent to a dividend, a redemption must result in a meaningful reduction of the shareholder’s proportionate interest in the corporation.

→ Note: constructive ownership rules apply under (b)(1).

Didn’t qualify for waiver of family attribution safe harbor because Davis only sold back the preferred, and still had common stock outstanding. The (b)(3) safe harbor wouldn’t apply, either, because the stock was nonvoting preferred, a transaction which can never avail itself to (b)(3) protection.

Revenue Ruling 75-502
What is the “meaningful reduction of shareholder’s interest” credo of Davis? Himmel (2nd Cir. 1964) says “shareholder interest” includes:

- The right to vote and thereby exercise control
- The right to participate in current earnings and accumulated surplus, and
- The right to share in net assets on liquidation.

In this example, buying out the shares of the estate alone would never satisfy for the (b)(3) safe harbor. For (b)(2), the estate owns 1000 of 1750 outstanding shares. After redemption the estate still constructively owns 50% – and (b)(2) requires < 50% immediately after redemption. (b)(1) works, though, because a 50/50 standoff in control is good enough to call a “meaningful reduction” because there is no more unilateral control over the corp.

→ However – look for who holds the “other” 50% of the stock. If it’s scattered, then there may still be effective control of the distributee.
Corporate Taxation Outline

Revenue Ruling 75-512
In this example, the trust will not have to worry about attribution to the parents, but it will to the son-in-law’s kids. Thus, it fails the \((b)(2)(C)(ii)\) 80% test, too. But just barely (attributable 24.x% from son-in-law’s children). So the IRS says basically, “Close enough, you get \(302(a)\) sale treatment.”

Revenue Ruling 85-106
C ahs the opportunity to call the shots in collaboration with A and B, so while C’s 18% is a minority, it is still part of a control group. This is a dividend.

Problems 219
1. Z corp, 100 shares. A, 28; B, 25; C, 23; D, 24. Dividend or not under \((b)(1)\)?
   (a) Near miss on \((b)(2)(C)(ii)\) 80% test (80% of A’s original 28% interest is 22.4%; after redemption with only 93 shares outstanding, control was 22.6%). 0.2% off, so near miss and “meaningful reduction” sale treatment OK.
   (b) Same as (a), but only five shares redeemed and A&D are related. Ownership before was 52% (w/attrition). After \((w/95\) shares outstanding) 49.4%. Passes \((b)(1)\).
   (c) Same as (b), except A&B are related instead. Ownership before was 53% (w/attrition). After \((w/95\) shares outstanding) 50.1%. Fails \((b)(2)(B) < 50\%\) test.
   (d) Same as (c), but A&B hate each other. Always apply attribution, regardless of family hostility.

Y corp, 100 C, 100 NVP.

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2. Will the following qualify for 302(b) exchange treatment?
   (a) Y redeems 5 preferred shares from E. No \((b)(1)\) substantially disproportional treatment because no voting stock redeemed, but legislative history says that it gets exchange treatment.
   (b) Y redeems all of its outstanding preferred stock. Redemption doesn’t affect A. E gets \((b)(3)\) safe harbor from complete termination of interest. No impact on vote, so probably a dividend on that claim alone. Vote is “key factor,” but is it determinative factor? Still earnings and liquidation rights factors outstanding. But looking beyond vote, what are the economic rights of the shareholders and how are they affected?
   1. B gets walloped going from majority of earnings stake to none. B should qualify for sale treatment under \((b)(1)\).
   2. C has minor economic impact, so no meaningful interest. Dividend treatment.
   3. D same as C.

3. Individual owns 10 common at $15K basis. What happens if to basis of five shares are redeemed in a transaction classified as a dividend?
   Should up the basis of individual’s remaining shares to carry forward the outstanding basis that was not recognized as a return to capital yet.
   What if all 10 shares were redeemed in a dividend transaction because the family attribution waiver was unavailable?
   See Reg 1.302-2 Example 2. Basis transfers to related party. Ouch.

3. Redemptions tested at the corporate level: Partial liquidations
   In kind proceeds – 311(b) (General Utilities doctrine repeal)
Corporate Taxation Outline

E&P reduction
i. 301 treatment
   Normal 312(a) and (b) rules for reduction of E&P distributed apply
ii. Sale treatment – 312(m)(7)
   Reduces E&P by amount distributed, but not more than shares proportionate contribution to E&P (reduction limitation)

A. Partial liquidations
302(b)(4), (e)
A redemption qualifying as a “partial liquidation” under 302(b)(4) are taxed to the distributee shareholder as a 302(a) exchange. 302(e) mandates that the focus of examination for whether a redemption is a partial liquidation is on the corporate level.

1. Exceptional features
   Must be noncorporate shareholders. Yes, they receive 301 and 243 DRD treatment; but 1059(e)(1)(A) will make it an extraordinary dividend and reduce the basis – creating capital gains and more tax. HOWEVER, 302(e)(4) pro rata redemptions will qualify for sale treatment.

2. Definition
   i. In general – major corp business contraction
   ii. Safe harbor – 302(e)(2), (3)

3. Policy – 331(a), (b)
   If there is a redemption that seems to be connected to a major corporate business contraction, then shareholders can go ahead and treat as partial liquidation for sale treatment. Controverts the Davis “meaningful reduction” credo, because the distribution in this instance would be pro rata (with no “meaningful reduction” across the board) and yet still get sale treatment. This is an exclusively corporate focus.

4. Disposition of controlled subsidiary
Revenue Ruling 79-184
332 controlled subsidiary liquidation requirement. If you first liquidate, then IRS has to treat the parent as if it had been operating independently. The subsidiary’s time can tack on to the parent to help meet the five-year period if the parent liquidates and distributes the proceeds. But what if parent just sells subsidiary’s stock instead of liquidating? No special treatment, because no 332 liquidation has occurred. The grace doesn’t carry if there is no transfer of taxable assets.

Note: If corporation simply distributes subsidiary’s stock, then corporate division rule in 355(a), (b) may apply – tax-free at both shareholder and corporate level if these provisions are met (same requirements as partial liquidation safe harbor in 302(e)(2))

Problem 223
(a) Sale treatment for M & P from safe harbor exception; corp gets 301, 243 DRD, 1059 mess. Pro rata distribution, so no other tax schemes would work.
(b) Ruins the five-year requirement for the safe harbor.
(c) 302(e)(1) – when unforeseeable event causes destruction, and then proceeds of insurance distribution are distributed to shareholders. Qualifies as sale treatment under general rule.
(d) Sale treatment as a partial liquidation.
(e) Iris is a corp, so it is a dividend. Partial liquidation only for non-corporate distributees. Only would qualify for sale treatment if Iris fell under one of the four 302 criteria. In this case, 302(b)(3) termination of interest applies, so sale treatment OK.
(f) Won’t qualify under safe harbor because of five-year existence test. Also doesn’t because it is a distribution of business assets and not a partial liquidation. See Reg 1.346-1(a).
Corporate Taxation Outline

(g) See RR 79-184. Parent attribution for subsidiary’s operation and business history.
(h) See RR 79-184. Parent attribution for subsidiary’s operation and business history.

B. Redemption planning techniques

1. Bootstrap sales

   Zenz 229 (6th Cir. 1954)
   Integrated, prearranged transaction that IRS lost on, and today would fall under sale treatment protection of 302(b)(3). Woman, intending to sell divest her interest in corp, sold part of her stock to a third party and then had the corp redeem the remainder as treasury stock for substantially all of the corp’s accumulated earnings and profits. IRS claimed that the payment from the corp was a dividend, Zenz claimed it was a 302 redemption. Led to Revenue Ruling 75-447 – the order of the steps doesn’t matter, but we recognize that we lost under Zenz, so the two transactions (Zenz redemption and then sale of stock, or reversed order of steps [sale of stock and then redemption]) will not be treated as a dividend. 302(b)(2) will be applied “when all the dust has settled” – by simply comparing stock ownership pre- and post-transactions.

2. Buy-sell agreements: Constructive dividend issues

   Revenue Ruling 69-608

   Arnes 250 (9th Cir. 1992)
   McDonald’s franchise redemption prompted because of divorce. Wife characterized that the stock redemption was actually sold to her husband pursuant to a divorce decree, and should have 1041 property settlement nonrecognition. Step 1 – she gets 1041 settlement. Step 2 – corporation redeems shares from husband (basically that he ripped off the corp for the purchase price of her shares). Husband gets hammered on 302(d) and 301 because constructive redemption to a 100% shareholder is essentially a dividend. She really screwed her ex.

   Note: IRS asserted deficiency against husband to compensate for the $450K lost from ex-wife, but lost because there is no collateral estoppel between the two proceedings (he was not a party to her proceedings, she was not a party to his proceedings).

   Grove 256 (2nd Cir. 1973)
   Charitable bailouts. Grove, majority shareholder of corp, claimed charitable contribution deduction under 170(e) for the FMV of his stock in corp donated to RPI. Corp redeems RPI’s stock, and RPI doesn’t care about their classification because they’re tax exempt. What if Grove had redeemed the stock first, and then donated the proceeds to RPI? IRS says Grove has no income, but is making a huge deduction. So IRS says look at it as a step transaction, and no matter how the steps are arranged, it should be termed a redemption that doesn’t pass 302 muster. Grove says RPI wasn’t under obligation to redeem shares, so it would be unfair to treat the two transactions as part of an integrated plan. Court bought it, regardless of Grove’s life interest in the donated stock and systematic contributions in the same style to RPI.

   170(f) has remedied Grove in further defining what can and can’t qualify for charitable contribution treatment.

C. Redemptions through related corporations

304 (except (b)(3)(C), (D), (b)(4)). Reg 1.304-2(a), (c) Examples (1), (3), and (4).

304 – Labeled as a redemption issue, but is it really about redemptions (read: other legislative intentions)? Look more towards financial stake or control gain/lost with the transaction. What’s different in 304 than a real redemption in a close corp? Assets leave the corp in terms of purchase price, but corp gets substitute assets in exchange.

What about parent/subsidiary transactions? Subject to heightened scrutiny. When all the dust settles in the transaction, look at the shareholder’s ownership interest in the parent corp.
Corporate Taxation Outline

Just know that when you have a sale of stock by a controlling shareholder to another corp that is controlled, \(304\) may apply if there hasn’t been a change in control sufficient to award sale treatment.

**Niedermeyer 268 (Tax Court 1974)**

304(a), (c)(3) – As messy as it gets. Sale of stock between corporations. 302(b) tests look to ownership of issuing corp. change in ownership is as to AT&T, so mom and pop go from 91% actual and attributable pre-transaction, 0% actual and 68% attribution post (for a net of 72% ownership when change in amount of outstanding stock is recalculated). Mom and pop think they pass 302(b) because they planned to completely terminate their interest with a family attribution waiver (and the transaction would qualify for 302(c)(2) “immediately” because the transaction was part of a single, integrated plan). No constructive ownership meant that their resulting interest would be 0%. Problems: more than one kind of outstanding stock; mom and pop still held preferred stock post-transaction (subject to a gift to charity). No family hostility exception, either.

**Problems 275**

1. In reading Niedermeyer, make sure you are able to answer the following:
   (a) Why did 304 apply to the sale by the taxpayers of their AT&T common stock to Lents?
   (b) Given that 304 applies, how do you test the “redemption” to determine if the taxpayers have a dividend?
   (c) Why were the taxpayers unable to waive family attribution?
   (d) How could they have avoided this unfortunate result?
   Answered generally in the case comment above.

2. Bail Corp, 100 shares, no accumulated earnings or E&P. Out Corp, 100 shares, $5K accumulated, no E&P. Claude, 80 Bail (basis = $500 per/$40K total), 60 Out (basis = $150 per/$9K total). Remaining shares owned by unrelated individual. Tax consequences when:
   (a) Claude sells 20 Out to Basis for $4K ($1K over basis)?
   (b) Same as (a), except Claude receives $3K and one Bail share (FMV $1K)?
   (c) Same as (a), except Claude receives one Bail share, and Bail takes the 20 Out shares subject to a $3K liability that Claude incurred to buy the 20 shares of Out?
   (d) Claude sells his Out shares to Bail for $12K?

**D. Redemptions to pay death taxes**

303(a), (b)(1)-(3), (c). Skim 6166.

One-time exemption from taxes for redemption of a decedent’s stock. Decedent’s redeemable stock must comprise over 35% of the entire estate, or aggregation may be allowed for two or more corps if at least 20% of the corps’ total outstanding stock is in the estate. For the latter test, stock held jointly in any manner may be included in the calculation.

**E. Stock Dividends and 306 stock**

305, 306, 317(a)

1. **Taxation of stock dividends under 305**

\(305(a)-(d); 307; 312(d)(1)(B), (f)(2); 1223(5)\).

**General rule:** Stock received tax-free under 305(a) is treated as a continuation of the recipient’s old stock. Accordingly, the basis in the old shares is divided among all shares total in relation to their FMV.

Ex. If B owns 100 Corp shares at $20 basis, and Corp distributes 1 for 1 stock dividend, then B ends up with 200 Corp shares and basis is spread down to $10 per.

**Exceptions:**

305(b)

(1) Optional stock or cash – The test is choice: *forced* to receive stock, or *opt* to receive stock? *Opting* negates the tax-free transfer.

(2) ¡Disproportionate distribution! Nobody may have a choice, but if the effect is that some have the opportunity to increase their stake in ownership, while others may just take cash or property, then the whole dividend is taxable.
Corporate Taxation Outline

(3) Common or preferred mix – Indicates future change in proportional ownership depending on corp’s future performance (different slices during liquidity/liquidation).
(4) Stock dividend ON preferred – Expands priority claim on future assets and earnings upon liquidation to the detriment of common shareholders.
(5) Convertible preferred – Basically (3) parade of horribles all over again.
(6) Constructive stock dividends – 305(c) repetitive redemption plans are constructive dividends and thus taxable.

Problems 289
1. Tax consequences on these “redemptions” in light of 305?
   (a) No tax.
   (b) Both Fay and Joyce are taxed, because B stock dividend was optioned. Frank is taxed because preferred holders had option (see statutory language “any”).
   (c) No tax on A dividend; B dividend taxed normally as income under 301. 1-305.3(b)(4).
   (d) Expands the preferred “bucket,” and runs into (2). Change of proportional interest. Two part test: in addition to proportional interest, someone has to walk away with money or property. That hasn’t really happened here, though, but the statutory parenthetical is broad enough to encompass that type of regular dividend stock. So fails part two of the test as well.
   (e) Frank still gets everything, even though there’s a new priority. The new priority doesn’t materially change anyone’s proportional interest, because Preferred A still retains its full preference to E&P before the subordinated preferred stock.
   (f) Debenture holders are stockholders because the debentures are convertible, and thus fall under the 305(d) definitions as shareholders. Becomes disproportionate distribution.
   (g) The conversion ratio on the preferred stock is designed to maintain the proportions of interest that existed under the unmodified plan. Should be no adverse tax consequences because the shareholder rights don’t change, and Frank’s common-to-common transfer is not in the 305 criteria. However, what about the “distribution” to Fay and Joyce on preferred stock? Well, any dividend on preferred should normally be taxable, but (b)(4) allows an exception that won’t enforce taxation if the “distribution” of a conversion ratio change is simply to preserve the interest of the preferred shareholders in light of a stock split.
   (h) Standard optional distribution that is taxable under 301.
   (i) Preferred convertible into common. Option again, since this is basically a two-step common stock distribution that will likely lead to a change in proportional share class ownership. Taxable unless the IRS passes it as not disproportionate – (b)(5). Test includes showing of incentives for conversion. In this case, because of the 20 year lifespan of the conversion, they will probably all convert if the business is in any measure successful (provided that other incentives make conversion unattractive). If everyone converts, then ownership interests will still be proportional. but it appears that Fay and Joyce are taxable under (b)(5) and Frank is taxable under (b)(3)(B).

2. 305(c) problems if Z corp agrees to annual redemption of 50 shares at the election of each shareholder, and A (500 shares) makes such an election two consecutive years? B (300) and C (200) do not elect.
That would depend on whether Z Corp has any current E&P. Anyway, not in form a stock dividend, but certain shareholder’s interest increase as this plan progresses. Redemption is processed under 302(a)(1) (303 or 304 possible, but not in this case). Well, not 20% termination of voting power, no to everything else... So look to “meaningful reduction in ownership” according to Davis. After the first redemption, B and C can combine respective vote to overturn anything A does where they couldn’t before. A gets sale treatment, B and C have constructive stock dividend ONLY if it is a redemption to which 301 applies. In this case, B and C pass Y1.
But in Y2, the redemption for A doesn’t meet the safe harbors, and A gets hit with 301 tax on that year’s redemption. Now 305(c) looms for B and C. They seem to have constructive, taxable dividend unless the redemptions are isolated. These redemptions are part of a periodic redemption plan, so they be sunk in Y2.

2. Section 306 stock
Corporate Taxation Outline

A. The preferred stock bailout

_Chamberlin 290 (6th Cir. 1954)_

Distribution of preferred stock that was fully intended to be immediately redeemable by certain parties to avoid taxes. Court OKed transaction, even with acknowledgment of the tax avoidance intent, because the firm hadn’t violated the law. Three-step transaction that made the essentially-dividend payment go to the insurance companies (Step 1: preferred stock dividend to Chamberlin; Step 2: sale of those preferred stocks to insurance companies; Step 3: redemption of preferred from insurance companies).

B. The operation of 306

i. **306 stock defined**

“Tainted” 306 stock is any stock other than common stock distributed by a corporation if received by the taxpayer tax-free under 305(a). Also includes stock received in a tax-free reorganization if the receipt of that stock had the effect of a dividend. Additionally, stock exchanged for 306 stock will also be 306 stock if received in a carryover basis transaction.

The tax-bailout hook comes when a company distributes this stock, and then redeems it later from the shareholder – avoiding the 301 taxable dividend status.

Of course, that leaves the question, “What is ‘common’ stock?” Typically, the IRS defines it as any stock, whether voting or not, that participates without substantial restriction in corporate growth.

- **RR 76-383** says that stock issued with a first right of refusal to the corp, but otherwise completely like common stock (meaning without limitation on future equity rights) is common stock because the right to sale will be a shareholder level decision to reduce equity.

- **RR 79-163** says that any stock issued in a restructuring that has limited rights to dividends or limited rights upon liquidation aren’t “common” stock.

ii. **Dispositions of 306 stock**

Two dispositions lead to different rules:

_Taxable:_ A taxable disposition of 306 stock will generally produce ordinary income to the transferor. If 306 stock is redeemed, the amount realized on the redemption is treated as a distribution, thus generating 301 income. The redemption of 306 stock may be treated as a dividend only to the extent of E&P at the time of the redemption. Otherwise, distributions in the red are treated as a normal return to capital – (c)(2).

_Sold:_ More complex “look back” rule. Seller will generate ordinary income to the extent that those shares would have been a dividend at the time of their original distribution. So the seller has to look back to the corp’s E&P a the time of distribution to calculate how much ordinary income they will realize on the current sale, and any excess realization is treated as a reduction in basis of the 306 stock. Excess beyond that is normal gain from sale of stock. The ordinary income cannot be claimed as a 243 DRD, and the issuing corp can’t reduce E&P when 306 stock is sold.

iii. **Dispositions exempt from 306**

Tax avoidance and the legislative solution to Chamberlin. Only schemes designed to thwart tax repercussions are subject to 306 taint. Therefore, 306 only applies when shareholders exercise a withdrawal of corporate earnings while retaining their same measure of corporate control. As before, exemptions are:

- Complete termination of interest (meaning disposal of stock with no attribution ramifications),
- 302(b)(3) termination of interest,
- 302(b)(4) partial liquidations,
Corporate Taxation Outline

- Redemptions of 306 stock in complete liquidations,
- Nonrecognition transfers (351 transfers, contributions to capital, etc.),
- Any distribution and disposition or redemption found by the IRS to not be part of a tax avoidance plan.

Fireoved 302 (3rd Cir. 1972)
The answer to Chamberlin. Fireoved redeemed preferred shares in a corp that he claimed under 306 exceptions as capital gain. Court disallowed, saying that redemption solely to avoid taxes took the preferred stock out of the 306 exceptions. Business judgment test cannot be used as a defense if there is no valid practical justification beyond tax avoidance.

Problems 309
1. In Y1, Argonaut Corp distributed nonconvertible, nonvoting preferred stock worth $1K to Jason and Vera, unrelated 50/50 common shareholders. Common basis of $2K prior to distribution and $3K immediately after. At time of distribution, Argonaut had $2K E&P. In Y3, Argonaut had $3K E&P. In Y3, Argonaut had $3K E&P.
   (a) Y1 tax consequences? Tax-free under 305(a) on distribution, but what about their basis?
      307(a) for associated basis on dividends says that for tax-free dividends, take the basis of the original stock and distribute it among the combined old and new stock proportionally. In this case, preferred + common post is $1K + $3K = $4K FMV. Then take common pre and distribute it proportionally according to the current FMV ($4K). Because $3K is ¾ of $4K, $1.5K basis of the $2K common pre is allocated to common post; the remaining $.5K (¼ of $4K) is attributable to preferred.
   (b) 306(a)(1)(A) says that Vera has $1K ordinary 301 income, limited only by the “ratable share” exception and invoking the (a)(1)(A)(ii) look-back rule to check Y1 if it had been cash instead of the stock distributed. Limit doesn’t come into play here because cash distribution in Y1 would have been $1K.
   (c) In this case, the $1K-would-have-been-dividend is automatically ordinary income ala (b), supra. Additionally, the look-back rule says that there is $750 excess over the would-have-been distribution. (a)(1)(B) says to add the ratable share limit ($1K) plus the associated basis ($500 from (a), supra) leaves $250 that gets capital gain treatment. That leaves $500 of tax-free return of basis. If Vera sold for just over the ratable share limit, then the excess basis would have been attributed to her remaining shares.
   (d) All transactions are OK. No taint if dividend wasn’t possible in the first place – (c)(2).
   (e) Any disposition (disposal) of stock that isn’t a redemption is taxable. (a), (a)(1).
      However, since there is no recognized gain or loss, (b)(3) says that as to Jason only (a) doesn’t apply. But this is a transfer of 306 stock, so it remains 306 tainted when Claude tries to sell it – (c)(1)(C). The sale becomes ordinary income to the extent of the look-back. The basis carries over from Jason. But Claude is completely terminating his interest in Argonaut, and there is no grandparent to grandchild attribution, so 306(b)(1) allows Claude to avoid 306 and he will receive LTCG treatment.
      If Jason had died, then 306 doesn’t apply and the stock isn’t tainted.
   (f) Redemption of Jason’s preferred for $1.5K and half of common for $5K?
      Common stock gets exchange treatment under 302(b)(2) because of the substantial reduction in control. Preferred is tainted, redemption was in Y3, in Y3 Argonaut has $3K E&P, and all of the preferred redemption is a dividend. (a)(2). The common becomes a $4.25K gain after basis ($750) is recovered, so what about 306(b)(4)(B)? Not in pursuance of plan principally for tax avoidance, but Jason only disposed of part of the common stock, so (b)(4) doesn’t apply. So what about that extra portion? It immunizes at least half of the common because there isn’t any bail-out feature of common stock. Only to the extent that you dispose of the underlying common stock that caused the 306 taint ...
   (g) None would qualify for the (b)(4) exception because the bylaws indicate that this is purely a tax avoidance move, implicating 306 taint and making all $1.5K receive 301 treatment.
Corporate Taxation Outline

(h) Yes, 306 stock; yes, redemption subject to 306(a)(2); but tax free return to capital because this is not a dividend but a return to capital.

2. Zapco Corp, 100 common (all owned by Sam Shifty), more than enough E&P.
   (a)
   (b)

F. Complete Liquidations
   1. Complete liquidations under 331
      A. Consequences to the shareholders
         331, 334(a), 346(a) 453(h)(1)(A)-(B); Reg 1.331-1(a), (b), (e).
         Normally treated as if shareholders had sold their stock to the corporation in exchange for the corp’s assets. 331(a). Typically, the liquidating corp recognizes gain or loss as if it had sold the distributed assets to the shareholders at FMV. Each shareholder recognizes gain or loss on the difference between their adjusted basis in the stock and the amount. Each shareholder takes a FMV step-up basis in the assets received.
         Corp sale of assets on an installment method over more than one year will allow shareholders to recover basis before reporting gain or loss.

      Shareholder level tax on corp earnings:
         Policy
         Timing – Shareholders are taxed on corp’s E&P only if and when the corp issues a dividend. Wiedenbeck says that the timing is wrong because it is not fixed.
         Taxpayer – Wrong
         Rate – 301(c)(1) ordinary income – Wiedenbeck says wrong again. Same for liquidation, where 331 turns return into capital gain treatment
         Compare:
         A) Corp sale of assets and corp liquidation;
         B) In-kind liquidation and shareholder sale of assets.

A) Step 1 corp sale of assets taxed under 1001 as corp level gain/loss recognition; Step 2 SH recognition under 331. Double tax in effect, right result.
Corporate Taxation Outline

B) Step 1 in-kind liquidation creates SH-level tax on stock appreciation under 331(a), but there’s no corp level tax on appreciated assets (pre-General Utilities) and shareholders will take 334(a) FMV basis.

Segue to next section: Congress remedied this discrepancy in same end result/different tax regimes problem by forgiving the corporate tax in the first example. In 1986, Congress revisited the issue and enacted 336 requiring corporate-level recognition.

Problem 315
A, 100 shares Humdrum, $10K basis. Humdrum has $12K accumulated E&P. Humdrum liquidates; tax consequences to A?
(a) Humdrum distributes $20K to A in exchange for stock?
(b) What if (a) above was a $10K distribution in Y1 and another $10K in Y2? Any problem with no formal plan of complete liquidation?
(c) (d)
(e)

B. Consequences to the liquidating corporation
336(a)-(d), 267(a)(1), (b), (c).

i. Background

Court Holding Co. 317 (1945)

Cumberland PSC 318 (1950)

ii. Liquidating distributions and sales
336(a) and recognition to the corp

iii. Limitations on recognition of loss
336(d)(1) “related person” recognition disqualification and (d)(1)(B) “disqualified property”: Distributions to related persons, i.e. controlling shareholders (see 267 for definitions), will not allow for recognition of loss if either (1) the distribution is not pro-rata among the shareholders, or (2) the distributed property was acquired by the liquidating corp in a 352 transaction or as a contribution to capital within the five-year period ending on the date of the distribution.

Policy on the pro-rata requirement? Congress presumably intended to single out situations where a majority shareholder receives an interest in loss property that is disproportionate to their stock interest in the corp.

Policy on disallowance for 351 nonrecognition exchange property loss?

336(d)(2) tax avoidance by “loss stuffing”: Prevents the doubling of pre-contribution built-in losses. Only applies if distributing corp acquired property in a 351 transaction or a contribution to capital as part of plan with principle purpose to recognize the loss on liquidation. Losses are limited to amount of loss accrued post-corp acquisition. Pre-contribution losses are deducted against the basis, but cannot fall below zero. Additionally, losses may not be recognized on any property obtained by the corp within two years of the adoption of a liquidation plan without Treasury approval.

Look at the above diagramed transaction. What if there is a third option, where shareholders sell their stock directly to the third party buyer (Step 1), and then the buyer in-kind liquidates (Step 2)? Triggers 1001 gain/loss at shareholder level; in-kind asset exchange invokes 336 asset level gain/loss. All of the first three are asset acquisitions.

What about a fourth option? Step 1, corp sale of assets; Step 2, no liquidation. 1001 asset g/l, invest sale proceeds in Step 2, but therein lies the rub. Any accumulated,
Corporate Taxation Outline

undistributed investment income will bring on an avalanche of penalty fees and earnings taxes (531, 541).

Fifth option: 1. SH sale of stock to 3PB; 2. 3PB doesn’t liquidate. 1001 stock g/l; avoids 336 corp level asset gains.

Sixth option: 1. SH sale of at least 80% stock; 2. 3PB is corp and liquidates. 1001 g/l; but in-kind liquidation defers corp tax to the shareholders upon sale of their shares. 336 → 337, 334(b), 381(a)(1).

Seventh option: 1. SH sale of stock; 2. 3PB elects 338. The Kimbell-Diamond case – step transaction, in substance a direct asset acquisition. Electing 338 considers the stock sale an asset acquisition. Would only make this election in three circumstances: if assets have net declined in value; if assets have appreciated, but if target corp has net operating loss carryovers; and

Eighth option: 1. SH sale of stock, SH is controlling parent corp; 2. 338(a) AND 338(h)(10) election. Parent liquidates sub in-kind, parent sells stock to 3PB. Opting into 338 turns transaction into simply corp level tax on asset gains.

Look for applicability of 338 on exam.

Problem 328

2. Liquidation of a subsidiary
   A. Consequences to the shareholders
      332, 334(b)(1), 1223(1); Reg 1.332-1,-2,-5.

      George L. Riggs, Inc. 331 (Tax Court 1975)

      Parent corp | 3PB
      -----------  | 332
      334(b) carryover basis | 331
      381(a)(1) E&P carryover | 336, 336(d)(3) no loss recog. on prop that has declined in value

      Subsidiary
      337

   B. Consequences to the liquidating subsidiary
      336(d)(3), 337(a), (b)(1), (c), (d); 381(a)(1), (c)(2), (3); 453B(d), 1245(b)(3), 1250(d)(3); Reg 1.332-7.
      No triggering of corp tax to the parent to the extent that the liquidated subsidiary’s assets are going to the parent. The assets are given a 334(b) carryover basis, and the tax will be caught up to later when shareholder sells stock (which will reflect parent’s value with additional liquidation proceeds).

III. Transfer of a Corporate Business

   A. Taxable Acquisitions

   B. Overview of Acquisitive Reorganizations
IV. Limits on the Retained Earnings Strategy
   A. Penalty Taxes