Part I–Introduction and Stakes

The issues considered here–choice of entity, debt vs. equity, and dividend vs. compensation all raise substance vs. form issues. They are a brief introduction to the problems caused by the so-called “double taxation” of corporate income. You will find a good overview in ALI Subchapter C Project.

Assignment

Code: §§ 1(a), (h); 11(a)-(b), 243(a), (b)(1), (c)
Regs: 301.7701-1(a), (d), -2(a), (b)(1)-(3), -3(a), (b)(1), (c)(1)(i)
Materials: Items 1-5, 7

Problems

1. Suppose T is in the business of producing widgets. After expenses, T has net revenues of $100. If T organizes as a C corporation (i.e. a corporation subject to subchapter C and subject to tax under § 11), pays corporate level tax and distributes the rest to himself as a dividend (see § 1(h)), how much cash will he have after taxes?

2. How will the answer change if he operates as a sole proprietor? See § 1(a).

3. How will the answer change if he operates as an S corporation? Or as a partnership (assuming he has a partner)? Why are the answers to 1-3 so different?

4. How will the answer change if he pays himself $100 of salary? Given the answer, you would expect many small corporations to pay out net income as salary. Does this effectively eliminate the corporate tax for privately held companies? Are there steps corporations should take to insure that this works? See O.S.C. Associates.

5. X Co. needs to raise additional capital. It can do so either by issuing debt or equity. Why might it choose one or the other? Why might an investor rather hold one or the other? Does it matter who will purchase the debt or equity (individuals, corporations, tax-exempt entities)? Consider tax and nontax factors.

6. Assume X Co. wants to issue debt for tax reasons, but “straight debt” is not very attractive for nontax reasons. Can it add some equity characteristics? If so, which ones? How is the issue of whether the instrument X Co. issues is debt or equity likely to arise? Why does Congress (or the IRS) care? Consider Fin Hay Realty v. United States, Ragland Investment Co. v. Commissioner, and Rev. Rul. 90-27.

7. Suppose your client’s creditors want him to drop business assets into an entity and pledge the equity interest taken in return as security for a loan. If one of these assets were subsequently sold, how could the client avoid the fate of the taxpayer in Moline Properties? Would your advice be the same if your client was a joint venture between two individuals?
Part II–Cash Distributions

In this part of the unit, we will consider the general rules for cash distributions by corporations to their shareholders. The basic rule is that distributions are taxed as dividends to the extent of earnings and profits, and then constitute basis recovery, and then capital gain. § 301(c). Dividends are defined by § 316 and rules with respect to adjustments are found in § 312. But it is necessary to use the regulations to figure out exactly how E&P is calculated and allocated. The point of these problems is to learn to calculate E&P, to calculate the amount that constitutes a dividend, and to consider variations based on the differences between current and accumulated E&P as well as variations based on timing.

Assignment

Code: §§ 243(a), (c), 275(a), 317(a), 301, 316, 312(a) thru (d)(1), (d)(3), 312(f)(1), 312(k)(3)

Regs: §§ 1.301-1(a), (b), (c), (g), (1); 1.312-6(a) (b), -7(b)(1); 1.316-1(a)(1), (e) Ex 1, -2(a), (b), (c)

Materials: Items 8-11

Problems

1. T Co. is an accrual method, calendar year taxpayer. T Corp is owned equally by two shareholders, A Co. and Mr. B (an individual). Both shareholders are cash method, calendar year taxpayers. T Co. is subject to tax at a flat 35% rate. A Co.’s basis in its T Co. stock is $100, and Mr. B’s basis is $40.

During the taxable year 2004, T Co. has the following:

a. T Co. engages in a like-kind exchange of real estate with a third party. In the exchange, T realizes gain of $75, none of which is recognized under § 1031(a). T’s basis in the property received in the exchange is the same as that of the property T Co. transferred in the exchange under § 1031(d).

b. T has gross income from business of $500

c. Dividend income (from Y Corporation of which T Co. is a 25% owner) of $100

d. Municipal bond interest of $100

e. Long term capital gain of $100

f. Deductible business expenses of $420

g. Interest expense of $80 on a loan incurred to buy the municipal bonds (see § 265(a)(2))

h. Capital losses of $150

On April 2, 2004 (one-fourth of the way through the year), T Co. distributes $100 cash to A Co. and $100 cash to Mr. B. As of 12/31/2003, T Co.’s accumulated earnings and profits ("E&P") account was zero. What are the tax consequences of the distributions to the parties? (To answer this question you will need to calculate the E&P. In that regard, see Bangor & Aroostook R. Co. v. Commissioner.)
i. How would the answer change if Mr. B owned all the stock in two blocks, one with an adjusted basis of $40 and one with an adjusted basis of $100?

2. What if, in addition to the April distributions, T Co. distributes $200 to Mr. B on December 1, 2004? (That might happen, e.g., if Mr. B buys A Co.’s stock in November, so that Mr. B owns 100% of the T Co. stock from then on).

3. What if, in addition to common stock, T Co. has 50 shares of preferred stock outstanding, each of which entitles the holder to an annual non-cumulative dividend of $1 per share payable on December 15. Under T Co.’s charter, holders of T Co. common stock are not entitled to receive dividends unless all preferred non-cumulative dividends are paid. Mr. B owns all 50 shares of T Co. preferred stock. In addition to the April distributions, on December 15, T Co. distributes $50 to Mr. B in respect of the T Co. preferred stock (assume that the December distributions under 2. do not occur). See Rev. Rul. 69-440.

4. Suppose instead that a $200 distribution is declared on 12/1/2004, payable on 12/31/2004 to shareholders of record on 12/15/2004. T Co. mails $100 checks to A Co. and Mr. B on 12/31/2004. The checks are received by A Co. and Mr. B on 1/3/2004. When do the shareholders have income? When does T Co. reduce its E&P? See Reg. § 1.51-2(b) (third sentence); § 1.301-1(b).

   i. How does the answer change if on 12/10/2004, Mr. B sells his T Co. shares to C for $540. Who will be taxed on the dividend? See Reg. § 1.61-9(c); Rev. Rul. 82-11.

5. Suppose T Co. has 2004 current E&P of $100 and an accumulated deficit of $100 in its E&P account as of 12/31/2003 and T Co. declares a distribution of $100 each to A Co. and Mr. B. What do the shareholders report? What is the effect on E&P?

   i. How would the answer change if T Co.’s accumulated E&P as of 12/31/2003 was $100 and its current E&P in 2004 was zero?

   ii. How would the answer change if T Co. had $100 accumulated E&P as of 12/31/2003 and its current E&P in 2004 was zero, the distribution to A Co. is on 4/1/2004, and the distribution to Mr. B is on 10/1/2004 (e.g., A Co. owned 100% of the T Co. stock during the first six months of the year and sold it to Mr. B mid-year)?

   iii. How would the answer change if T Co.’s accumulated E&P as of 12/31/2003 was $100 and T Co. has 2004 E&P of negative $120? See Rev. Rul. 74-164.

6. Suppose T Co. has 2004 E&P of $1,000 and on 12/31/2004 declares and pays a $100 dividend to each of A Co. and Mr. B. What rate of tax (considering the benefit of any related deduction) will apply to the dividend received by each shareholder assuming both held their stock throughout 2004? See § 1(h)(11) (which incorporates § 246(c)) and § 243.

   i. What if Mr. B purchases his T Co. stock on 12/1/2004 and sells it on 1/30/2005. What rate for Mr. B on the 12/31/2004 dividend?
Part III—Distributions of Property (Including debt instruments)

The distribution rules become more complex when the corporation distributes property (most likely with a privately held corporation), including debt instruments (more likely with a publicly held corporation). First you need to figure out the tax consequences to the corporation, the calculate the E&P and then figure out the tax consequences to the shareholders. As always, the last step is to calculate the E&P going forward.

Assignment

Code: §§ 311, 336(b), 312(a)-(b), 453B(a), (b)

Materials: Item 14

Problems

Assume that T Co. has no accumulated E&P. T Co.’s current E&P for 2004 is $100 not considering the effect of the distributions in the subparts below and net of any accrued tax liabilities. The only distributions made by T Co. during 2004 are as indicated below. For each subpart, determine the tax consequences to the parties.

1. T Co. distributes bonds of AT&T with a basis of $30 and a value of $90 to A Co. and bonds of AT&T with a basis of $50 and a value of $90 to Mr. B. What do A Co. and Mr. B report? See § 311, 312(b). What is their basis in the bonds? See § 301(d). What is T Co.’s E&P on 1/01/05? See § 312(a)(3).

   i. How would the answer change if the bonds distributed to A secure a nonrecourse note of $50? See § 301(b)(2), 312(c).

2. Suppose the bonds distributed to A Co. had a basis of $140 rather than $50. See § 311(a).

3. Suppose instead that T Co. distributed to A Co. and Mr. B its own negotiable (but not publicly traded) notes, each with a face amount of $100, fair market value of $90, and bearing a market rate of interest payable annually. (Because these notes pay interest annually at a market rate and are not publicly traded they do not bear original issue discount even though each note is worth less than its face amount. §§1273(b)(4); 1274(a), (c); 1275(a)(4). Thus the original issue discount rules have no application to these facts.) See § 311(b)(1)(A); 1271.

4. In 2004, when T Co. has current E&P of $300, T Co. sells two parcels of land, each worth $100 and having a basis of $60, one parcel each to A Co. and Mr. B, in each case for $75 in cash. What consequences to the parties? See Rev. Rul. 58-1
Part IV–Dividend Received Deduction

Assignment

Code: §§ 243(a), (b)(1), (b)(2)(A), (c); 246(c); 1059 [only skimming (d)(6), (e),(3) & (f)]; Skim §246A

Materials: Item 16

Problems

1. T has owned 70% of TSub for several years. A taxpayer unrelated to T owns the other 30% of TSub. TSub has thousands of dollars of accumulated E&P. T has a basis of $75 in its TSub shares; they are worth $200. T wants to sell its TSub stock; P has expressed interest in purchasing it. Although T and P have reached no formal agreement, they have agreed in principle to the following three-step deal.

- Immediately before selling its TSub shares to P, T will cause TSub to create and distribute a note with a face amount and FMV of $70. TSub will also distribute a note with a face amount and FMV of $30 to its minority shareholder.
- T will sell its TSub stock to P for $130, TSub's then FMV. (The dividend will cut TSub's value by $100; 70% of the decline will be reflected in the value of T's TSub shares.)
- P will make a capital contribution of $100 to TSub. TSub will use the funds to repay the notes distributed to T and the minority shareholders before the sale.

If the form of the overall transaction is respected, what are the consequences to the parties?

How might the government seek to recharacterize the transaction? How do courts evaluate whether the form of transactions like this should be respected? See Litton Industries.

Would it make a difference if P were to buy the note from T directly for $100 at the same time that it buys the T stock, instead of contributing to T the wherewithal to pay the note? (Assume if P followed this course, it would also buy the note from the minority shareholder.)

2. Two days before the ex-dividend date, Z Co. buys 10 shares of the common stock of GE on the New York Stock Exchange (NYSE) for $100 per share ($1,000 total). If Z Co. were to sell the GE shares the next day, would ZCo. or the buyer be legally entitled to the dividend? See Rev. Rul. 82-11.

   i. If Z Co. receives a dividend of $10 per share (a total of $100) from GE six weeks after the purchase, and Z sells the GE stock for $90 per share ($900 total) two weeks after that, what result to Z Co.? See § 246(c).

   ii. What if Z Co. purchases the stock three rather than six weeks before the dividend (i.e. Z Co. purchases the stock two days before ex-dividend date, then held for three weeks, received dividends, and sold two weeks later). What result to Z Co.? See §246(c).

   i. Would the answer change if, on March 1, 2004, ABC were trading at $110 per share? See §1059(c)(4).

   ii. Would the answer change if the ABC dividend were $8 rather than $10 per share? See § 1059(c)(3).

   iii. Suppose P Co. had acquired all of ABC's stock rather than just 10 shares. How does the result change? See § 1059(e)(2).