Stock Dividends & §306 Stock

A stock dividend is defined as:
A distribution by the issuer corporation of its own stock to its shareholders.
Alternative types of dividend distributions:
1) cash;
2) property (e.g., (a) land or (b) stock of another corporation); or,
3) stock of the distributing corporation.
Possible Types of Distributions of Stock

1) Same class of stock (e.g., common on common) - to retain the corporation’s cash.

2) A different class (e.g., preferred stock distributed on common stock) - to enable preferred status for some shareholders.

3) Rights or warrants to acquire stock of the distributor - to facilitate obtaining additional cash infusions from some shareholders who can buy stock at an advantageous price.

Stock Split vs. Stock Dividend

What financial accounting and State Business Corporation Act treatment?

Stock dividend - requires an allocation from earned surplus to stated or paid-in capital for the distributing corporation.

Stock split - no required allocation; objective is to make the price of the stock more attractive for trading.
Stock Distributions Before Code §305

Eisner v. Macomber - a distribution of a stock dividend is not "income" in the U.S. Constitutional sense (16th amendment).

But, does (should) the power to tax income include the power to define “income”?

Sequel: §305(a) - gross income does not include the amount of any distribution of stock on stock. Also, §306 - preferred stock bailouts & postponed ordinary income.

Code §305(b) Exceptions - Income Recognition

1) §305(b)(1) - distribution in lieu of money - election to the shareholder to take cash or stock - resulting in a change in proportional stock ownership.

2) §305(b)(2) - disproportionate distributions occurring as a result of: (i) the receipt of property by some shareholders; and (ii) an increase in the proportionate share interests in corporation of others.
Code §305(b), continued

3) §305(b)(3) - distribution resulting in the receipt of (i) preferred stock by some common shareholders, and (ii) common stock by other common shareholders.

4) §305(b)(4) - distribution on preferred stock (except for capital adjustments).

5) §302(b)(5) distribution of convertible preferred - unless establishing that not resulting in a disproportionate distribution.

Treatment to Recipient Shareholder - Other Effects

1) Allocation of tax basis in proportion to the relative fair market values of various shares on the date of the distribution. §307(a).

2) Tacking of the holding period. §1223(5).

3) §305 impacts a stock rights distribution.

4) §307(a) - allocation of tax basis when rights are distributed, but, not if rights value is less than 15% of the stock value. §307(b).
Example

Frank Fay Joyce
100 Class A 50 Class B 50 Class B

(a) Prorata distribution is made of nonconvertible preferred stock to both classes of shareholders.

Nontaxable distribution under § 305(a).
The §305(b) exceptions are not applicable.
But, cf., the §306 preferred stock provision.

Example 1, cont.
Option to Take Cash

(b) Pro-rata distributions are made, but Class B shareholders have the option to take cash.

§305(b)(1) - Class B shareholders have the option to be paid in either stock or property.

Reg. §1.305-2(a)(5) provides that, if all or part of the shareholders have an election, then, with respect to all shareholders, a §301 distribution occurs - even though only part of the shareholders have the election.
Example 1, cont.  
**Cash Paid on One Class**

(c) Pro-rata distribution of Class A on Class A and cash distribution on Class B.

Class B - §301 taxability on cash distribution.
Class A - distribution is taxable under §305(b)(2). The distribution has the result of (i) the receipt of property by some shareholders (Class B), and (ii) an increase in proportionate interests (in assets and E&P) of other shareholders, i.e., the Class A shares.

Example 1, cont.  
**Preferred Paid on Common**

(d) Class B stock is nonconvertible preferred paying cash dividends. Class B stock is distributed to Class A shareholder.

If cash dividends are being paid on the Class B shares the distribution to the Class A shareholders will be within §305(b)(2).

Further, the Class A shareholder will have increased his proportionate interest in Corp's assets and earnings and profits.
Example 1, cont.
Upgrade to Junior Stock

(e) Same as (d), but Hill distributes to Class A shareholders nonconvertible preferred stock with rights to assets and E&P subordinate to the existing Class B stock (i.e., "junior" nonconvertible preferred). This distribution does not increase the proportionate interest of the Class A shareholder - the distribution is not within §305(b)(2)(B) and no dividend treatment occurs to the Class A shareholder.

Example 1, cont.
Convertible Debentures

(f) Outstanding are: (i) One class of common stock, and (ii) 10% debentures convertible into common at the rate of one share of common for each $1,000 debenture. Interest is paid and later a "common on common" stock dividend is distributed to common stock holders without a conversion ratio adjustment. §305(d)(2) – the debenture holders are "shareholders". The common stock received is taxable to the common shareholders.
Example 1, cont.
Conversion Rate Changed

(g) Debentures are convertible preferred. Corporation declares a 1-for-1 split on the common. The conversion rate on the preferred stock is doubled. Result: the proportionate interest of the common stockholders is not increased by the stock split since the preferred conversion ratio is fully adjusted. The common stock distribution is not taxable - §305(a).

Example 1, cont.
Preferred & Common

(h) Class A and Class B are both classes of voting common stock. Hill makes a distribution of (i) Class A on Class A and (ii) a new nonconvertible preferred on Class B. A taxable distribution results to both Class A and Class B shareholders under §305(b)(3). What relevance to estate planning?
Example 1, cont.  
Convertible preferred stock

(i) Preferred stock distributed is convertible into Class B stock over 20 years at B's market price on the date of the distribution.

See §305(b)(5) - convertible preferred stock.

Distribution to the Class B shareholders will be taxable unless the distribution does not result in a disproportionate distribution.

Here likely non-taxable - conversion possible over 20 years at distribution market price.

Example 2  
Z Corporation §305(c)

Z agrees to redeem annually 50 shares of stock at the election of each shareholder.

A makes this election for two consecutive years. §305(c) problem. What result?

<table>
<thead>
<tr>
<th>Year</th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>50%</td>
<td>47.4%</td>
</tr>
<tr>
<td>B</td>
<td>30%</td>
<td>31.6%</td>
</tr>
<tr>
<td>C</td>
<td>20%</td>
<td>21%</td>
</tr>
</tbody>
</table>
Example 2 cont.
Z Corp. - Share Redemption

<table>
<thead>
<tr>
<th>Year</th>
<th>Before</th>
<th>After</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>47.4%</td>
<td>44.4% (400/900)</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>31.6%</td>
<td>33.3% (300/900)</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>21%</td>
<td>22.2% (200/900)</td>
<td></td>
</tr>
</tbody>
</table>

Cf., isolated redemptions which are not part of a periodic redemption plan do enjoy immunity from §305(c). See Reg. §1.305-3(b)(3), (e), Examples 10 & 11.

Code §306 - Preferred Stock Bailout

Chamberlain decision
Declaration of a preferred stock dividend.
All shareholders sold to insurance companies the preferred received in the distribution.
The preferred was redeemed by the insurance company over a 7 year period.
Held: The stock dividend was an issuance of stock in substance as well as in form.
Code §306 Structure

1) The receipt of the preferred stock (i.e., not common stock) is not a taxable event.
2) The stock bears a "taint" which triggers income recognition at some later date, i.e., a sale or a redemption of the preferred stock.
3) Definition of §306 stock: Other than common on common - §306(c)(1).
Issue: Does the "common" have participation in the growth of the corporation’s equity?

Rev. Rul. 79-163

Situation 1: Corporation had 100x shares of common issued in the exchange:
1) Class A common - voting $20 par.
2) Class B common - nonvoting $100 par.
Cash dividends in the ratio of the par values. Neither class was redeemable.
Upon liquidation only par value to Class A.
Held: Class A is §306 stock. continued
**Rev. Rul. 79-163, cont.**

Situation 2: Equal rights to participate in dividends to 6% of the par value after which Class B participates for the remaining cash dividends (i.e., Class B can receive all the additional benefits of the equity growth).

Liquidation distribution will be proportionate to the par values of the shares.

Held: The Class A stock is §306 stock.

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**Rev. Rul. 76-386**

Recapitalization plan - §368(a)(1)(E).

Corporation X issues new voting common and new nonvoting common prorata.

Corporation had a right of 1st refusal to purchase voting common at net book value.

Issue: Is the new voting common treated as "common stock" for purposes of §306(c)(1)(B)?

Yes, i.e., not §306 stock.
Possible Acquisitions of §306 Stock

1) Preferred stock dividend.
2) Gift & transferred basis.
3) Tax-free merger.
4) Holding company structuring (see §306(c)(3)).

Dispositions of §306 Stock – Sale

1) Sale of §306 Stock - §306(a)(1).
A ratable share of the earnings and profits when the stock is distributed is ordinary income realized upon the subsequent sale of this stock.

2003 tax legislation: §306(a)(1)(D) provides for “dividend” treatment for §1(h)(11) purposes (i.e., the 15 % individual tax rate on dividends).
Dispositions of §306 Stock – Redemption

2) Redemption of §306 stock - §306(a)(2).
The amount realized on the redemption of §306 stock is treated as a §301 distribution.
I.e., measurement of the dividend effects (including E&P) occur as of the date of the redemption (and not as of the date of distribution of the §306 stock).

Dispositions Exempt from Code §306 Treatment

1) §306(b)(1)(A) - non-redemption but a complete termination of interest.
2) §306(b)(1)(B) - a §302(b)(3) redemption or a §302(b)(4) partial liquidation.
3) §306(b)(2) - a complete liquidation.
4) §306(b)(3) - a nonrecognition transaction.
5) §306(b)(4) - transactions not in avoidance of federal income taxation.
Fireoved case

§302(b)(4) issue - concerning what is "not in avoidance of tax".

1) Distribution of stock dividend pursuant to a plan having as one of its principal purposes the avoidance of federal income tax.

2) Effect of the earlier sale of 24% of the shares of common stock?

3) FIFO rule application. Were 65 of the 451 preferred redeemed from the original issue?

Example 1

Argonaut distributed preferred worth $1,000 to two unrelated equal common shareholders. To each the common had a tax basis of $2,000 prior to the distribution and a value of $3,000 immediately after distribution. Corp. had $2,000 prior earnings and profits. In year 3 Corp. had $3,000 of e&p. continued
**Example 1(a)**

What effect of the distribution in year one to:

**Shareholders:** (i) Nontaxable distribution under §305(a), (ii) preferred under §306(c)(1)(A); (iii) tax basis in preferred is determined under §307 allocation according to the relative fair market values.

**Corporation:** (i) No gain recognition on the distribution of the preferred - §311(a)(1); (ii) Earnings and profits are not adjusted.

**Example 1(b)**

Vera sells the preferred stock to Carl, an unrelated party, for $1,000 in year three.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized</td>
<td>1,000</td>
</tr>
<tr>
<td>Tax basis</td>
<td>500</td>
</tr>
<tr>
<td>Gain</td>
<td>500 LTCG</td>
</tr>
</tbody>
</table>

But, assuming §306(a)(1) applies.

1) Impact to Vera? Ordinary income? Basis?
2) Impact to Argonaut? No e&p adjustment.
Example 1(c)

Vera sells the preferred stock to Carl for $1,750. (Query: How can this nonconvertible preferred appreciate to $1,750?)

1) $1,000 of ordinary income. §306(a)(1)(A).
2) $500 basis recovery.
3) $250 capital gain.

Example 1(d)

Argonaut had no E&P at the time of the distribution of the preferred stock.
The preferred stock would not be §306 stock - §306(c)(2).
The sale for $1,000 produces $500 gain.
($1,000 amount realized less the $500 tax basis).
Example 1(e)

Jason gives the preferred stock to grandson, Claude, who later sells stock for $1,000.
1) Gift is not a disposition triggering §306.
2) Claude takes the preferred with:
   a) $500 basis - §1015(a).
   b) §306 taint - §306(c)(1)(C).
3) Sale - $1,000 ordinary income or $500 basis recovery and $500 capital gain?

Example 1(f)

Argonaut redeems one-half of Jason's common stock for $5,000 and all of his preferred stock for $1,500.
Redemption qualifies for exchange treatment under §302(b)(2). After the redemption Jason owns 33% of the combined voting power and Vera owns 67%. Jason holds (i) less than 50% and (ii) less than 80% of 50%.
Example 1(g)

Same as (f) but different voting requirements - i.e., unanimous shareholder agreement required for corporate action.
1) Redemption of the common qualifies as an exchange under §302(b)(2); but -
2) Redemption of the preferred - §306(b)(4)(B) exception will not apply; corporate control is maintained.

Example 1(h)

Same as (f), but Argonaut has no E&P in year three.
Redemption of common under §302(b)(2).
Assuming Code §306(b)(4) does not apply:
Preferred shares: Still Code §306 stock?
$1,500 distribution - §301;
but, none is dividend, since no e&p.
Recovery of basis of $500 and gain of $1,000?
Example 2(a)

Zapco has 100 com. shares owned by Sam. Sam forms a holding company by transferring 50 Zapco shares in exchange for:

i) 100 shares of Holding common stock &
ii) 100 shares of Holding preferred stock.

Holding Co. preferred stock will be §306 stock under §306(c)(3).

Example 2(b)

Step One:
Sam                                    Selma
50 Zapco common      50 Zapco common

Step Two: All Zapco stock into Holding Co.
Sam receives                Selma receives
100 shares                50 shares holding com.
holding common 50 shares holding pref.

Issue: Is Selma’s preferred §306 stock?