Presentation:

Corporate Taxation
Chapter Six: Stock Dividends & §306 Stock
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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)

3) Debt of distributing corporation, or

4) Stock of the distributing corporation.
1) **Same** class of stock (e.g., common on common) – dividend made to retain the corporation’s cash.

2) A **different** class (e.g., preferred stock distributed on common stock) to enable preferred ownership 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 based on the pricing of the stock right.
What (1) **financial** accounting and (2) Texas Business Organizations Code treatment?

**Stock dividend** – requires an allocation from earned surplus to stated or paid-in capital account for the distributing corp.

**Stock split** – no required allocation to paid-in capital; objective is to make the price of the stock more attractive for trading.
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 of tax income include the power to define “income”?

Sequel: (1) Code §305(a) – gross income does not include any distribution of stock on stock. (2) Code §306 – preferred stock bailouts produce postponed ordinary income.
1) §305(b)(1) – distributions in lieu of money – election available to the shareholder to take cash or stock – this results in a change in proportional stock ownership for all.

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 the corporation by others.

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

4) §305(b)(4) – distributions on preferred stock (except for capital adjustments).

5) §302(b)(5) – distributions of convertible preferred – unless establishing that not resulting in a disproportionate distribution.
1) Allocation of tax basis in proportion to the relative fair market values of various shares on the date of the distribution. Code §307(a).

2) Tacking of the holding period. §1223(4).

3) Code §307(a) – allocation of tax basis when rights are distributed, but, not if rights value is less than 15% of the total stock value. §307(b).
Plan of redemption where shareholders could elect to participate. 8 shareholders elected to participate.

**Issue #1:** Did redeeming shareholders have a dividend? Yes.

**Issue #2:** Did nonredeeming shareholders have a constructive “stock dividend” since their ownership interest in Z was increased due to actual redemption of the other 8 shareholders? Yes.
(a) Prorata distribution is made of nonconvertible preferred stock to both classes of shareholders.

RESULT: This is a nontaxable distribution under §305(a). The §305(b) exceptions are not applicable. But, c.f., the §306 preferred stock provision.
(b) Prorata distributions are made, but Class B shareholders have the option to take cash.

RESULT: §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.
(c) Prorata distribution of Class A on Class A and cash distribution on Class B.

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

RESULT: 
1. Class B: Cash dividends being paid on the Class B (preferred) shares included under §301.
2. Class A: 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 & profits. Exception for fractional share payments.
(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., distribution of “junior” nonconvertible preferred).

RESULT: This distribution does not increase the proportionate interest of the Class A shareholder – the distribution is not within §305(b)(2)(B) & no dividend treatment occurs to the Class A shareholder.
Problem 1(f) 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 then a “common on common” stock dividend is distributed to common stock holders without a conversion ratio adjustment. What distribution amount? 1:1?

RESULT: §305(d)(2) – the debenture holders are treated as “shareholders”. The common stock received is taxable to the common shareholders.
(g) Debentures are convertible preferred.

Corporation declares a 1-for-1 split on the common. The conversion rate on the preferred stock is doubled (i.e., two shares common for debenture).

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).
(h) Class A and Class B are both voting common. 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 of this type of transaction to estate planning (e.g., “estate planning recapitalization”)?

Reg. §1.305-3(e), Example 12.
Problem 1(i)
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 nontaxable: Why? Full conversion probable over 20 years at the distribution price.
**Problem 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?

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A has meaningfully reduced ownership  
A has not meaningfully reduced ownership
Chamberlain decision (p.304) involved corporation declaring a preferred stock dividend. All shareholders sold to insurance companies the preferred stock received in the stock distribution. The preferred stock was redeemed by the insurance company over a 7 year period.

Held: The stock dividend was a nontaxable issuance of stock in substance and in form.

Implication: If left unchanged, the impact was to allow bail-out of E&P at capital gains rates via the sale of preferred stock.

Congressional response: Enacted §306.
1) The receipt of the preferred stock (i.e., not common stock) is not a current taxable event.

2) The stock bears a “taint” which triggers income recognition at some later date, i.e., upon a sale or a redemption of the preferred stock.

3) Definition of §306 stock: Other than common on common – Code §306 (c)(1).

Issue: Does the “common” have participation in the growth of the corporation’s equity?
Corporation issued 100x of common in exchange for:

1) Class A common – voting $20 par.
2) Class B common – nonvoting $100 par.

**Situation 1:** 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 because limited participation at time of liquidation.

**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 because rights to ongoing dividends is limited.
Recapitalization plan – Code §368(a)(1)(E). Corporation X issues new voting common and new nonvoting common prorata. Corporation X has a right of 1st refusal to purchase voting common at net book value.

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

Holding: New stock is common stock and thus is not §306 stock. Shareholder has choice of whether to dispose of stock and doing so gives up right to future growth in Corporation X.
Possible Acquisitions of §306 Stock

1) Preferred stock dividend.

2) Gift & transferred basis stock.

3) Tax-free merger (e.g., recapitalization).

4) Holding company structuring, i.e., drop-down into sub (see §306(c)(3)).

Not when through an estate (§1014 basis step-up is applicable to also eliminate the §306 taint).
1) **Sale of §306 Stock - §306(a)(1).**

Amount realized upon the sale of §306 stock is treated as ordinary income except to the extent that the amount realized exceeds the ratable share of the earnings and profits that existed at the time the §306 stock was distributed. In 2003, §306(a)(1)(D) was added to provide for “qualified dividend” treatment for §1(h)(11) purposes (i.e., the 20% individual tax rate on dividends).

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).
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.
Distribution of preferred stock is §306 stock unless an exception applies. Fireoved says stock dividend did not have a principal purpose of tax avoidance.

Holding: One of principle purposes was tax avoidance. Fireoved still retained veto control and so preferred stock redemption was a means to obtain cash without reduction of effective control. Where the §306 stock and other preferred was represented in a single stock certificate, court held that the redemption would be treated as a pro rata redemption of the section 306 stock.
Argonaut distributed preferred worth $1,000 to two unrelated equal common shareholders. Each shareholder had common with a tax basis of $2,000 prior to the distribution and a value of $3,000 immediately after the distribution. Corp. had $2,000 prior earnings and profits. In year 3 Corp. had $3,000 of E&P. What is the effect of the distribution in year one?

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

2. **Corporation:** (i) No gain recognition on the distribution per §311(a)(1); (ii) Earnings and profits are not adjusted.
Vera sells the preferred stock to Carl, an unrelated party, for $1,000 in Year 3.

Amount realized: 1,000
Tax Basis: 500
Gain: 500

But, §306(a)(1) applies.
1) Vera treats $1,000 as a qualified dividend. $500 basis shifts over to her remaining stock.
2) Argonaut: Argonaut cannot reduce E&P by $1,000. See Treas. Reg. §1.306-1(b)(2) (so stating). Section 306(a)(1)(D) provides the IRS the authority for a contrary result if they issue regulations but the Treasury Department has not done so.
Vera sells the preferred stock to Carl for $1,750.

1) $1,000 of ordinary income. §306(a)(1)(A).
2) $500 basis recovery. 
   (1/4\textsuperscript{th} of $2,000 basis)
2) $250 capital gain. 
   ($750 - $500 allocable basis)
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 allocated tax basis). Gain would be LTCG.
Jason gives the preferred stock to grandson, Claude, who later sells stock for $1,000.

1) Gift is **not** a disposition triggering §306 taint.

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?
Problem 1(f)  
Gift of §306 Stock to Charity

Jason gives the preferred stock to charity. What may Jason deduct?

No clear answer. One view is that the charitable deduction is limited to the ordinary income component in the preferred stock per §170(e)(1)(A), so $500.

Other view is that the charitable deduction is $1,000 since the qualified dividend is taxed the same as long-term capital gains.
Argonaut redeems one-half of Jason’s common stock for $5,000 and all of his preferred stock for $1,500.

1. Redemption of common stock 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%.

2. Redemption of the preferred stock implicates §306. Since Argonaut has $3,000 E&P ($1,500 is Jason’s share), then all $1,500 of the preferred stock redemption is a taxed as a qualified dividend. There is a possibility that the preferred stock redemption may fall within the § 306(b)(4) exception as a transaction "not in pursuance of a plan having as one of its principal purpose the avoidance of tax."
Same as (g) 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. So, all $1,500 treated is treated as related to a §306 transaction and taxed as a qualified dividend
Same as (g), but Argonaut has no E&P in year three.

1) Redemption of the common qualifies as an exchange under §302(b)(2).

2) Preferred stock is §306 stock. The $1,500 is treated as a distribution, but none of the $1,500 is taxed as a dividend since Argonaut has no E&P. Although not entirely clear, Jason should get basis recovery of $500 plus remaining $750 in other common stock and the remaining $250 should be gain per §301(c)(3).
Zapco has 100 common shares owned by Sam. Sam forms a holding company by transferring 50 (of 100) Zapco shares in exchange for:

i) 100 shares of Holding common stock, and

ii) 100 shares of Holding preferred stock.

Holding Co. preferred stock will be §306 stock under §306(c)(3).
**FACTS:** Sam & Selma contribute all their Zapco stock to Holdco. Sam receives 100 shares of common stock while Selma receives 50 common stock and 50 preferred stock.

**ISSUE:** Is Selma’s preferred §306 stock?

**RESULT:** If Selma had received cash, not preferred stock, the transaction would have received exchange treatment per §302(b)(2) since Selma's interest in Zapco was 50% before the exchange and she owns 33 1/3% of Zapco via attribution rules in §306(c)(4) after the exchange. So, if cash had been received, not preferred stock, Selma would not have had a dividend. So, the Holdco preferred stock is not §306 stock.