

Chapter Six – (1) Stock Dividends & (2) §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);
- 3) debt of distributing corporation; or,
- 4) stock of the distributing corporation.

Possible Types of Distributions of Stock

- 1) Same class of stock (e.g., common on common) – dividend is 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/will buy issuer's stock at an advantageous price based on the stock right.

Stock Split vs. Stock Dividend

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What (1) financial accounting and (2) Texas Business Organizations Code (TBOC) treatment?

Stock dividend – (e.g., 3 shares for 100 sh. owned) requires an allocation from earned surplus to stated or paid-in capital account of the distributing corporation. What is the purpose of this allocation?

Stock split – (e.g., 1 additional share for 1 share then owned) - no required allocation to paid-in capital; objective is to make the price of the stock more attractive for trading.

Stock Distributions Before Code §305 p.298

Eisner v. Macomber - a distribution of a stock dividend is not "income" in the U.S. Constitutional sense (16th amendment), rejecting the Revenue Act of 1916 provision that a stock dividend is income.

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

Subsequent Sup. Ct. litigation (p.298-299) issue:
Did an increase/decrease occur in a shareholder's proportionate interest in the corporation?

Stock Distributions & Code §305, cont. P.299

Legislative sequel (1954 Code, Regs. & the 1969 Tax Reform Act):

(1) Code §305(a) - gross income does not include any distribution of stock on stock, subject to various exceptions where the proportionate ownership interest in corp. is changed.

(2) Code §306 - preferred stock bailout produces postponed ordinary income to the recipient shareholder.

Code §305(b) Exceptions - Income Recognition

- 1) §305(b)(1) - distributions in lieu of money – election is available to the shareholder to take cash or stock – this results in a change in the 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.

Code §305(b), continued

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 of stock on preferred stock (except for capital adjustments).

5) §302(b)(5) distributions of convertible preferred - unless establishing that the arrangement does not result in a disproportionate distribution.

Stock Redemption Plan

Periodic small redemptions by shareholders of a closely held corporation. Small changes in ownership resulting from these distributions.

Issue 1: Redeeming shareholders not eligible for §302(a) exchange treatment. No §302(b) exceptions apply. Therefore, §301 (dividend) distributions.

Not isolated occurrences for these redemptions.

Redeeming shareholders did not have “meaningful” reductions in their share interests. *continued*

Rev. Rul. 78-60, cont.

Stock Redemption Plan

Issue 2: Remaining shareholders had small percentage increases when other shareholders redeemed small percentages. See §305(b)(2) & §305(c) regs. prescribing §301 dividend treatment for those shareholders who had share percentage increases (when redemptions were not isolated transactions and were treated as dividend distributions).

Treatment to Recipient Shareholder - Other Effects

1) Taxable? Dividend distribution is FMV of stock & then an E&P reduction for distributing corp.

2) Non-taxable? Allocation of tax basis in proportion to relative fair market values of various shares on the date of the distribution. §307(a).

Plus: Tacking of the holding period. §1223(5).

3) §305 impacts a stock rights distribution.

4) §307(b) – no allocation of tax basis when rights are distributed & value of rights is less than 15%.

Problem - Hill Corporation Common Stock Held P.308

Frank	Fay	Joyce
<u>100 Class A</u>	<u>50 Class B</u>	<u>50 Class B</u>

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

This is a nontaxable distribution under §305(a).

The §305(b) (taxable) exceptions are not applicable.

But, cf., the §306 preferred stock provision.

Problem 1(b)

p.308

Option to Take Cash

(b) Pro-rata distributions are made, but (only) 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 to take cash.

Problem 1(c) p.308

Cash Is Paid on One Class

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

Class B - §301 taxability of the 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) increase in proportionate interests (in assets and E&P) of other shareholders, i.e., Class A shares.**

Problem 1(d)

p.308

Preferred Paid on Common

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

Cash dividends are being paid on the Class B (preferred) shares & are included under §301.

Distribution to the Class A shareholder will be within §305(b)(2). The Class A shareholder will have increased his proportionate interest in Corp's assets and earnings & profits.

Problem 1(e) p.308

Upgrade(?) for Junior Stock

(e) Same as (d), but Hill distributes to Class A shareholders nonconvertible preferred stock with rights to assets & E&P which is subordinate to the existing Class B stock (i.e., distribution of a "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) & no dividend treatment occurs to the Class A shareholder (§305(a)).

Problem 1(f)

p.308

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. (1) Interest is paid on debentures and then (2) a “common on common” stock dividend (1:1?) 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. §305(b)(2).

Problem 1(g)

p.308

Conversion Rate Changed

(g) Debentures are convertible preferred.

(1) Corporation declares a 1-for-1 split on the common, & (2) the conversion rate on the preferred stock is doubled (i.e., now two common shares receivable for each 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).

Problem 1(h) p.308

Preferred & Common

(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., an “estate planning recapitalization”)? Reg. § 1.305-3(e), Ex. 12, permits nonrecognition. Cf., corp. recapitalization.

Problem 1(i)

p.308

Convertible preferred stock

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

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 is probable over 20 years at the distribution price.

Problem 2

Z Corporation

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§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. A §305(c) problem? No §301 dividend for A? Why?

<u>Year 1</u>	<u>Before</u>	<u>After</u>	
A	50%	47.4%	(450/950)
B	30%	31.6%	(300/950)
C	20%	21%	(200/950)

Increase of the share % interests of B and C.

Problem 2 cont. Year 2

Z Corp. - Share Redemption

<u>Year 2</u>	<u>Before</u>	<u>After</u>	
A	47.4%	44.4%	(400/900)
B	31.6%	33.3%	(300/900)
C	21%	22.2%	(200/900)

No §302(b)(1) here for A (& B&C have §305(c)).

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

p.309

Chamberlain decision – noted, p.309

Facts: Declaration of 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 (& not a disguised sale of stock by shareholders to the corporation).

Code §306 Structure

p.310

- 1) The receipt of preferred stock (i.e., not common stock) is not a current taxable event. §305.
- 2) The stock bears a "taint" which triggers income recognition at some later date, i.e., upon a sale or a redemption of this preferred stock.
- 3) Definition of §306 stock: Other than common on common - Code §306(c)(1).

Issue: Does the "common" have a participation in the growth of the corporation's equity?

Rev. Rul. 79-163

fn. 34, p.311

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. Fn. 34, p.311

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 & Class A receives none).

Any liquidation distribution will be proportionate to the par values of the shares.

Held: The Class A stock is §306 stock.

Rev. Rul. 76-386

fn. 35, p.311

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

Corporation X issues new voting common and new nonvoting common pro-rata.

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, voting common stock, i.e., not §306 stock, since a right exists to participate in corp. growth.

Possible Acquisitions of §306 Stock

p.311-2

- 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 stock passes through an estate (i.e., §1014 tax basis step-up at death is applicable to also eliminate the §306 taint).

Dispositions of §306 Stock

– Sale p.312

1) Sale of §306 Stock - §306(a)(1).

A ratable share of the earnings and profits when the stock is originally distributed is ordinary income to be 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 20% individual tax rate on dividends).

continued

Dispositions of §306 Stock – Redemption p.312

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 & E&P reduction) occur as of the date of the redemption (and not as of the date of distribution of the §306 stock).

Dispositions Exempt from §306 Treatment **p.314**

- 1) §306(b)(1)(A) - non-redemption but a complete termination of interest (e.g., sale).**
- 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 p.315

Is §306(b)(4) Applicable?

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

- 1) What relevance of not attempting to obtain a "private letter ruling" from IRS? None.
- 2) Was the distribution of the preferred stock dividend pursuant to a plan having as one of its principal purposes the avoidance of federal income tax?

continued

Fireoved case

p.315

§306(b)(4) Applicable?

3) What effect of earlier sale of 24% (24 of 100) of shares of common stock? Does this sale immunize (under §306(b)(4)(B)) a portion of the subsequent preferred stock sale from §306? But, here no change in control occurred when common was sold.

4) Possible FIFO rule application. Were 65 of the 451 preferred shares redeemed from the original issue and, therefore, not § 306 stock? Holding 65/600 of preferred shares not §306 stock – but, no FIFO rule since all 600 issued at the same time.

Problem 1

p.321

Preferred Stock Distribution

Argonaut distributed preferred worth \$1,000 to two unrelated equal common shareholders.

To each shareholder 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

Problem 1(a)

Stock Distribution

p.321

What effect of the distribution in year one to:

Shareholders: (i) Nontaxable distribution under §305(a); (ii) preferred stock under §306(c)(1)(A); (iii) tax basis in the preferred stock is determined under §307 allocation rules according to the relative fair market values (1,500 to common & 500 to pref).

Corporation: (i) No gain recognition on the distribution of the preferred stock - §311(a)(1); (ii) Corp's. earnings and profits are not adjusted.

Problem 1(b)

Sale to Third Party

p.321

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

Amount realized	1,000
Tax basis	<u>500</u>
Gain	500 LTCG

But, assuming §306(a)(1) applies:

- 1) Impact to Vera? 1,000 ordinary income? Tax basis for preferred goes back to common stock.
- 2) Impact to Argonaut? No e&p adjustment.

Problem 1(c)

p.321

Sale for a Larger Amount

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

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

Problem 1(d)

p.321

No E&P at Distribution

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 of the preferred for \$1,000 would produce \$500 gain (the \$1,000 amount realized less the \$500 allocated tax basis).

Problem 1(e)

Gift of §306 Stock

p.321

Jason gives the preferred stock to grandson, Claude, who later sells preferred stock for \$1,000.

- 1) Gift is not a disposition triggering §306 taint.
- 2) Claude does take the preferred with:
 - a) \$500 basis - §1015(a).
 - b) §306 taint - §306(c)(1)(C).
- 3) Sale by Claude – (a) \$1,000 ordinary income, or (b) \$500 basis recovery and \$500 capital gain.

Answer: (b) - since end of shareholder interest (?).

Problem 1(f)

p.321

Gift of §306 Stock to Charity

Jason gives the preferred stock to a charity.

No charitable deduction for the ordinary income component in the preferred stock.

§170(e)(1)(A) – only the \$500 basis is deductible, since ordinary income characterization for the remaining portion. Or, is a different result applicable when a 20% tax rate applies to dividends and capital gains? Doubtful.

Problem 1(g) Stock Redemption

p.321

Argonaut redeems one-half of Jason's common stock for \$5,000 and all preferred stock for \$1,500.

Redemption of common qualifies for exchange treatment under §302(b)(2).

Before the redemption Jason owns 50%; 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%.

Simultaneous redemption of the preferred treated as an exchange - §1.302-3(a)? *Next slide*

Problem 1(g), cont. Stock Redemption

p.321

Effect on the preferred redemption? Piggyback on the common? Not when §306 stock. Reg. §1.302-3(a). Therefore, \$1,500 for the preferred stock is treated as a dividend distribution - §306(a)(2).

Presumably no §306(b)(4) eligibility.

Preferred stock tax basis goes to the common.

Reduction by Argonaut of its E&P: (1) \$1,500 for the preferred, and (2) \$375 for common, i.e., 25% of all stock is redeemed and 25% of remaining \$1,500 of E&P is \$375. §312(n)(7).

Problem 1(h)

p.322

Voting Control Restrictions

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)(?), except what impact of unanimous consent of shareholders?;
- 2) Redemption of the preferred - the §306(b)(4)(B) exception will not apply; corporate control is maintained.

Problem 1(i)

No E&P

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Same as (g), but Argonaut has no E&P in year three.

Redemption of the common qualifies under §302(b)(2).

Assuming Code §306(b)(4) does not apply: The preferred shares are still Code §306 stock; \$1,500 distribution under §301; but, none of the distribution is dividend, since no e&p. Therefore: Recovery of basis of \$500 and gain of \$1,000?

Problem 2(a)

p.322

Holding Company Creation

Zapco has 100 com. 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, &
- ii) 100 shares of Holding preferred stock.

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

Would be a dividend under §304(a)(1) & 304(b)(2) if cash received (rather than stock).

Problem 2(b)

p.322

§306 Stock Dropdown

Step One: 100 Zapco common outstanding

Sam

Selma

50 Zapco common

50 Zapco common

Step Two: All Zapco stock into Holding Co.

Sam receives

Selma receives

100 shares (not §306)

50 shares Holding com.

Holding common

& 50 shares Holding pref.

Issue: Is Selma's preferred §306 stock? No. Not dividend treatment (under §304(a)(1)) if money had been received. Her interest: 50% to 33 1/3%.