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Stock Redemptions

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INTRODUCTION

Recently I attended a dinner where the guests were certified public accountants. The face of the dinner menu represented a Federal income tax return for reporting income received during the year ended December 31, 1914. The net income so reported was subject to a normal tax of one per cent after deduction of the personal exemption. The net income in excess of \$20,000 and not in excess of \$50,000 was subject to an additional or super tax of one per cent. At such rates, an individual having net income of \$50,000 was required to pay a tax of about \$800.

We have come a long way since 1914 in many areas and whether we have made progress is for you to decide. In the field of income taxation we have experienced a great increase in rates. These rates have become so high and their application to members of the population so broad that everywhere one goes he hears people talk of deductions and capital gains. Everyone is striving to treat his income, to the extent possible, as a long-term capital gain.

The high tax rates applicable to individual incomes seem to me to result in greater use of the corporate form in conducting business. Under the corporate form of operation the corporation's net income is subject to a tax rate presently not in excess of 52 per cent and, subject to certain limitations, the net income can be accumulated in the business. Some of our largest so-called growth corporations clearly indicate what can be accomplished in this area and each one of us, in his own practice, can recall small-sized clients who have been able to build up substantial equities by operating policies calling for retaining earnings in the business.

The earnings thus retained in the business may be distributed in three general ways. One method consists of distributing such earnings as ordinary dividends but it is not pertinent to this paper. A second method consists of completely liquidating the corporation by distributing all its property in exchange for its stock. A third method consists of redeeming a portion of the outstanding stock and continuing the business by the company.

STOCK REDEMPTIONS PURSUANT TO A PLAN OF LIQUIDATION

It seems to me that the subject of stock redemptions should include reference to the types of transactions whereby all the stock of a corporation is redeemed by way of liquidation of the corporation. There are several sections of the Internal Revenue Code applicable to this type of transaction which I shall discuss but briefly, since other participants in this Tax Institute may direct your attention to such problems.

Under the provisions of Section 331 of the Internal Revenue Code, amounts distributed in complete liquidation of a corporation shall be treated as full payment for the stock. This transaction would be treated as a sale or exchange and would permit the holder of the stock in the corporation to treat his gain as a long-term capital gain, provided the stock had been held for at least six months. The value of the property received is its fair market value and such value becomes the basis in the hands of the recipient. This result applies either to an individual stockholder or to a corporate stockholder provided the latter holds less than 80 per cent of the stock as set forth in Section 332(b).

In some cases, when liquidation of a corporation and redemption of its stock are being contemplated, it may be desirable to consider bringing the transaction within the provisions of Section 333 of the Internal Revenue Code. Enactment of this section contemplated the extension of a measure of relief to personal holding companies wishing to liquidate. The section deals with complete liquidations which take place within one month. This form of transaction may be very desirable where the corporation holds property greatly appreciated in value. Liquidating the corporation and redeeming its stock in such a case may result in deferring recognition of gain upon such assets until their ultimate disposal. Thus recognition of gain can be controlled and spread over various years.

However, this type of redemption may be quite costly to an individual stockholder if the corporation to be liquidated has any appreciable amount of earnings and profits, for the reason that gain is recognized to the extent that it represents his share of earnings and profits, or cash and stock or securities acquired after December 31, 1953, whichever is greater. The portion of the recognized gain equal to his share of earnings and profits is taxed as an ordinary dividend and the remainder is taxed as a capital gain, either long-term or short-term, depending upon the holding period. For a corporate stockholder, all of such gain is taxed as a capital gain. This

requirement seems to be obvious in the light of the dividends-received credit available to corporations.

An example will serve to explain how the foregoing provisions apply. A is an individual who has held one share of X corporation for more than six months. The share of stock cost him \$50. At the date of liquidation corporation X has accumulated earnings and profits of \$25 a share. Pursuant to a plan of liquidation under Section 333, A surrenders his share of stock and receives \$40 in cash and other property valued at \$60 or a total of \$100. A has an over-all gain of \$50 but it is recognized only to the extent of \$40. Of this gain of \$40, he must report \$25 as an ordinary dividend and \$15 as a long-term capital gain. The basis of the other property becomes \$50 which represents the cost of his stock less the cash received plus the gain recognized.

I had an experience about four years ago which serves to point out the hazards of use of this type of liquidation. One of our clients was giving consideration to a liquidation and redemption of stock under this section. We had just become auditors for the company and decided that we should be sure book earnings and profits and tax earnings and profits were the same. A study soon demonstrated that tax surplus exceeded book surplus by over \$1,500,000. Needless to say the plan was abandoned. It may be interesting to note that one taxpayer did proceed under the comparable section of the Internal Revenue Code of 1939 and was permitted by the Court to revoke his election when it was determined tax surplus was greatly in excess of book surplus. The case is the Estate of Robert B. Meyer (200 Fed. 2nd. 592), but I suggest you do not rely upon receiving such favorable treatment if your client should liquidate under this section and later find out tax earnings and profits greatly exceed book surplus.

There are a number of other sections dealing with redemption of stock by complete liquidation of a corporation. These sections are noted herein only for reference. There is Section 332 which deals with liquidation of subsidiaries and Section 334 which deals with the basis of the assets thus acquired. This latter section has interesting possibilities as material for an examination of basis but discussion of it is not within the scope of my topic. There are also interesting possibilities in Section 337 which are to be covered fully by another speaker. Section 341 deals with collapsible corporations and is apt to give trouble. This section also may be discussed by another speaker.

It may be of interest to observe that some people believed that some of the dangers of the collapsible corporation section could be bypassed by use of a one-month liquidation. This was possibly true under the Internal

Revenue Code of 1939 but it does not appear true under the Internal Revenue Code of 1954, since the section dealing with one-month liquidations (Section 333) specifically excludes collapsible corporations from its provisions.

STOCK REDEMPTIONS NOT PURSUANT TO A PLAN OF LIQUIDATION

In considering the various problems relating to this type of stock redemption, there are certain general rules which should always be kept in mind.

Section 317 of the Internal Revenue Code contains two important definitions. Subsection (a) provides that for purposes of Part 1 of Subchapter C the term "property" means money, securities, and any other property except stock or rights to acquire stock of the corporation making the distribution. This definition makes it clear that an exchange of stock for stock may not be classed as a redemption. Subsection (b) provides that if a corporation acquires its stock from a stockholder in exchange for property, the transaction shall be treated as a redemption whether or not such acquired stock is canceled, retired, or held as treasury stock.

Section 318 of the Internal Revenue Code deals with the matter of constructive ownership of stock. The provisions of this section are important because many transactions including redemptions of stock must meet certain ownership tests and the provisions of this section may apply. Thus the following rules regarding constructive ownership must be observed:

- An individual shall be considered to own the stock owned directly or indirectly by his spouse (unless legally separated), his children, including those legally adopted, his grandchildren, and his parents.
- An individual shall be considered to own his proportionate part of stock owned by a partnership, estate, or trust of which he is a partner or beneficiary. Provision is made for exclusion of ownership relating to certain contingent interests.
- If an individual directly or indirectly owns 50 per cent or more in value of stock in a corporation he shall be treated as owning, proportionately, the stock owned by such corporation, and such corporation shall be treated as owning stock owned directly or indirectly by such individual.
- If an individual holds an option to acquire stock of a corporation, for purposes of constructive ownership he shall be deemed to have exercised such option.

The section also contains rules as to the order in which the various tests enumerated above are applied.

Section 302 provides that if a corporation redeems its stock for property such redemption shall be treated as a distribution in part or full payment in exchange for such stock, *provided* one out of four tests is met. Let us now consider these four tests.

The first test states that a redemption of stock is treated as a distribution in part or full payment in exchange for such stock if it is not essentially equivalent to a dividend. This test is clearly one wherein the burden of proof is placed upon the taxpayer and is the only one of the four tests which is not definite. The regulations applicable to this subsection do not offer a great deal of help but suggest generally that the burden of proof rests in much the same way as under Section 115(g) of the Internal Revenue Code of 1939. Nevertheless certain general observations can be made regarding this test.

- If the corporation has only one class of stock outstanding, a pro-rata redemption of a part of such stock will be treated as essentially a dividend. There is an exception to this rule if there is a partial liquidation.
- If the corporation has more than one class of stock outstanding, the redemption of part or all of one class of stock will generally result in a dividend, provided the stock is not of the type described in Section 306, and provided the ownership of all classes of stock is proportionate.
- A redemption might have a genuine business purpose and yet be treated as a dividend. Revenue Ruling 56-182 holds that the redemption of part of the stock of the majority stockholder so as to make it available for sale to a minority stockholder represents a dividend, as the majority stockholder did not lose control.
- If a redemption of stock qualifies as a redemption it is satisfactory if the price paid includes accrued dividends, provided such dividends have not been declared as such.

The second test is strictly a mathematical test. It states that if the distribution is substantially disproportionate with respect to a stockholder the transaction is a redemption. To be applicable, the stockholder must own, immediately after the redemption, less than 50 per cent of all voting power in the corporation and his ownership of such stock after the redemption must be less than 80 per cent of what it was prior to the redemption. For example, if immediately prior to the distribution, stockholder A owns 40 per cent of the voting stock of the corporation, more than 8 per cent of his stock must be redeemed in such a transaction. The section and the Committee Reports dealing with the Internal Revenue Code of 1954 make it

clear that if there is a plan or series of distributions the over-all result must be considered. Thus if A and B own the stock of a corporation and if a part of A's stock is redeemed this year and a part of B's stock is redeemed the next year, the over-all result must be viewed. The fact that each distribution by itself is substantially disproportionate is not controlling. In making the computations mentioned above it should be understood that the rules regarding constructive ownership are applied.

The third test is also relatively simple to apply. It provides that a distribution is a redemption if it is in exchange for all of the stock held by the stockholder. It must be remembered that here again the rules regarding constructive ownership must be applied. However, there is one important exception. The stockholder may exclude the test relating to all members of his family provided his only interest in the corporation after the distribution is that of a creditor, he does not reacquire any stock of the corporation other than by bequest or inheritance in the next ten years, he agrees to notify the Secretary if he does acquire stock within ten years other than by bequest or inheritance and maintains necessary records to enable the Secretary to assess the tax properly due if the distribution were treated as a dividend. The statute of limitations is open for such an adjustment but the Committee Reports indicate no other adjustments of income are to be made. In its simplest terms this test means that if a father and son owned the stock of a corporation, all of the father's stock could be redeemed and his interest would be considered as terminated if he met the foregoing requirements. It should be emphasized that the constructive ownership tests between an individual and a partnership, trust, estate, or controlled corporation are always applied.

The fourth test appears to be of limited application. It deals with a distribution relating to stock in a railroad corporation which was issued under a plan of reorganization under Section 77 of the Bankruptcy Act. Such a distribution is treated as a redemption with respect to the stock surrendered by the stockholder.

To summarize the foregoing matters, it can be said that if the stockholder meets tests two, three, or four he can be sure the distribution will be treated as a redemption, but if he cannot meet any of these three tests he should proceed with caution and consider the desirability of requesting a ruling from the Commissioner of Internal Revenue regarding the contemplated distribution as to qualification under the first test.

A recent case — that of Louis H. Zipp (28TC32) — decided by the Tax Court under the law applicable to the year 1950 is of interest. The facts are briefly as follows: The father owned 48 shares of stock in a corporation and

each of two sons owned 1 share. In 1947 the father gave each son 23 shares and filed gift tax returns. In 1950 the father received some \$94,000 in payment for the 2 shares he then held. The \$94,000 was the book value attributable to the 48 shares. The Tax Court held that the 1947 gifts were unreal and that the father had received \$94,000 for redemption of his stock. It further held that each son had received constructively a dividend of \$47,000. We have not heard the last of the case as the taxpayer has filed an appeal in the Court of Appeals for the Sixth Circuit.

The decision does not conform to a ruling received by my office about five years ago. The ruling concerned a determination of the result of a redemption by a corporation of 90 per cent of its stock from a family group of stockholders who were not related to others who held the remaining 10 per cent of the stock. It was held that the money and property received by the 90 per cent stockholders represented a distribution in partial liquidation and no reference was made to tax consequences attributable to the 10 per cent stockholders. It may be significant that the minority and majority stockholders were not related and that an outside offer to purchase the 90 per cent stock ownership was also present in the case.

The foregoing discussion related to redemption of stock which is not treated as Section 306 stock. This type of stock is subject to special rules which are discussed below.

DISPOSITIONS OF CERTAIN STOCK

Prior to enactment of the Internal Revenue Code of 1954, a popular device to take earnings out of a corporation at capital gain rates was by means of a preferred-stock bailout. Under this type of transaction a corporation would declare a dividend upon its common stock which would take the form of preferred stock. The preferred stock so distributed would generally represent an issue created for the purpose. The receipt of such preferred stock would constitute a tax-free dividend. The preferred stock would then be sold to other parties on a capital gain basis. Subsequently the corporation would redeem the preferred stock from the buyer. The case of *C. P. Chamberlin* (207 Fed. 2nd. 462) (Certiorari denied) represents a good example of this type of transaction.

With enactment of the Internal Revenue Code of 1954, this type of transaction has lost its attraction. Section 306 of the Internal Revenue Code of 1954 deals with this situation and provides the rules for redemption of such stock. The section defines Section 306 stock as any one of the following:

- Stock (other than common on common) issued as a non-taxable stock dividend under Section 305(a);
- Non-common stock received in connection with a tax-free reorganization to the extent that the transaction has substantially the effect of receipt of a stock dividend;
- Stock having a substituted basis derived from Section 306 stock;
- The first two situations do not apply if the corporation had no earnings and profits at the date of distribution.

Upon the sale of such stock the proceeds are ordinary income to the extent of the stock's ratable share of earnings and profits at the date the stock was distributed. The remainder of the proceeds is treated as a capital gain to the extent it exceeds the basis of the stock sold. Upon redemption of such stock by the corporation such distribution shall be treated under the provisions of Section 301 as a dividend to the extent of its ratable share of earnings and profits at the date of distribution and the remainder as applicable to the basis of such stock. The foregoing results do not apply if any of the following conditions are present:

- Stockholder terminates his entire stock interest by sale or redemption. Sale must not be to a related person under Section 318(a).
- Stock is redeemed in a partial or complete liquidation.
- Stock is surrendered in a tax-free exchange.
- Stockholder can satisfy Commissioner that disposition or redemption is not principally a tax-avoidance plan.

My office has had experience with this problem and in one case has obtained a ruling to the effect that the receipt of preferred stock and common stock for common stock necessitated recognition of such preferred stock as Section 306 stock, but that as applied to minority holders the plan was not used for tax avoidance. The stock of that company is listed on an exchange and it can be said that ordinarily, in the case of a listed corporation, a plan is not considered as being used for tax avoidance unless the concentration of stock ownership indicates a tax-avoidance purpose.

From the preceding discussion it can be seen that before any stock redemption is to be undertaken, the fact of whether the rules of Section 306 apply must be determined. If such rules do not apply the problem may well be solved. If such rules do apply it may be possible to produce the desired result by complying with one of the four exceptions discussed above.

A recent Revenue Ruling introduces an interesting side light to the problem of redemption of Section 306 stock. In Revenue Ruling 57-328, the Internal Revenue Service holds that Section 306 stock may be conveyed to a tax-exempt charitable foundation and, when no prearrangement as to

sale by the foundation or redemption by the corporation exists, the gift is a deductible contribution and no income results to the donor at that time or on later sale by the foundation. In a proper case the result appears to be equal to a tax-free redemption of stock. This type of transaction might have considerable appeal for a high-bracket taxpayer who wants to take full advantage of his contribution limit by giving away what probably would be appreciated property, since the fair value would probably exceed the basis.

DISTRIBUTIONS IN REDEMPTION OF STOCK TO PAY DEATH TAXES

Still another method by which capital gain treatment is obtained upon distributions in redemption of stock is in connection with estate-tax liability. Section 303 of the Internal Revenue Code of 1954 provides that if certain requirements are met, the amount of any distribution which does not exceed the total estate, inheritance, legacy, and succession taxes including interest collected as a part of such taxes, and funeral and administration expenses allowed as deductions to the estate, shall be treated as a distribution in full payment for the stock so redeemed.

In order to qualify for such treatment the distribution must be made subsequent to the death of the decedent and prior to 90 days after expiration of the three-year period of limitations for assessment of Federal estate tax or within any time before 60 days after a Tax Court decision becomes final.

A further requirement is that the distribution must relate to stock whose value includible in the estate is at least 35 per cent of the gross estate or at least 50 per cent of the taxable estate. In meeting these tests, corporations owning 75 per cent or more are treated as one corporation.

This section takes precedence over others to the extent of distributions which meet the tests of the section. All distributions in excess of the specified amounts are governed by such other sections as are applicable.

REDEMPTIONS THROUGH USE OF RELATED CORPORATIONS

Prior to 1950 the following type of transaction was used to achieve a capital gain. If A, an individual, owned control of corporation X and X owned subsidiary Y, A would sell some of the stock of corporation X to corporation Y. Under the decisions in this sort of case the proceeds were not

a taxable dividend to A. The case of *Commissioner vs. Trustees Common Stock John Wanamaker Philadelphia et al.* (178 Fed. 2nd. 10) well illustrates this type of sale. The Revenue Act of 1950 attempted to correct this situation. In substance it provided that, if a subsidiary acquired stock of its parent from a stockholder of the parent, the amount received by the stockholder would be considered a dividend to the extent it would have been considered a dividend if the subsidiary had distributed such amount to the parent and the amount had been applied by the parent in a redemption of its stock.

This same principle has been enacted as a part of the Internal Revenue Code of 1954 and in addition the same principle has been extended to transactions involving two or more corporations which are 50 per cent or more controlled by the same person or persons. This latter type of related ownership is described informally as being that of brother-sister corporations.

Section 304 of the Internal Revenue Code of 1954 deals with this problem and the substance of the law is set forth below.

- If a brother corporation acquires stock in a sister corporation from the person or persons controlling such two corporations, the property received by the stockholders shall be considered as a distribution in redemption of the stock of the acquiring corporation and the stock so acquired shall be considered as having been received as a contribution to the capital of the acquiring corporation.
- If a subsidiary corporation acquires stock of its parent from a stockholder of the parent, such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

Under each type of transaction it is presumed that the distribution shall be treated as a dividend unless the recipient can demonstrate that the distribution should be treated as a redemption under Sections 302(a) or 303. Thus under Section 302(a) it would be necessary to demonstrate that (a) the distribution is not essentially a dividend, (b) the redemption is substantially disproportionate, (c) the stockholder's interest is terminated, or (d) the stock is that of a railroad corporation reorganized under Section 77 of the Bankruptcy Act. In making the tests the section dealing with constructive ownership is applied as before except that in ascribing corporate stockholdings to its stockholders the 50 per cent ownership requirement is disregarded. The test under Section 303 is that relating to redemptions to pay death taxes.

If the amount distributed is considered to be a dividend in whole or in part the amount so treated depends on the type of corporate relationship concerned. If a parent-subsidiary relationship is concerned the determina-

tion is by reference to the earnings and profits of the parent after reflecting receipt of the amount distributed by the subsidiary. If a brother-sister corporation relationship is concerned the determination is made by reference to the earnings and profits of the acquiring corporation.

It can be seen that this type of transaction can produce redemptions at capital gain rates. It is no easier than by a direct redemption but in some cases it may be preferable due to the cash position of the various companies concerned.

DISTRIBUTIONS IN PARTIAL LIQUIDATION

Heretofore we have dealt with two general types of redemptions of stock. One type represents redemptions of all the stock, is accompanied by complete liquidation of the corporation, and results in equal treatment for all stockholders. The other type represents redemptions of a part of the stock, is not accompanied by complete liquidation, and importantly, must not be characterized by equal treatment.

Section 346 of the Internal Revenue Code of 1954 deals with the subject of partial liquidations. It provides rules whereby distributions may be made pro rata to all the stockholders of a corporation and the recipients may treat such amounts as in redemption of the stock surrendered.

Generally there are two types of distributions which can qualify under this section and they are:

- A distribution which is one of a series of distributions in redemption of all the stock of a corporation pursuant to a plan of complete liquidation;
- A distribution which is not essentially equivalent to a dividend, but is in redemption of part of a corporation's stock pursuant to a plan, and takes place within the taxable year in which the plan is adopted or within the succeeding taxable year.

The second type may or may not be a distribution resulting from termination of a portion of the business. In some cases contraction of the business might represent a bona-fide reason for the distribution. In other cases a termination as defined in the section is necessary. Sections 1.346-1(a) and 1.346-1(b) of the Regulations deal with distributions which result from contraction or termination of a business. There seems to be a distinction drawn therein but it is my understanding the present view of the Internal Revenue Service is that a termination is a type of contraction. As to a distribution resulting from contraction, the Regulations state that, if a portion of the assets were destroyed by fire, the distribution of fire

insurance proceeds could qualify as a partial liquidation. In order for a distribution to qualify under the provisions relating to discontinuance of a part of the business, the distribution must be attributable to the termination of conduct of a trade or business which had been conducted by the corporation for a five-year period prior to the date of distribution. Such trade or business must not have been acquired by the corporation during such period in a taxable transaction. Also after the distribution the corporation must be actively engaged in another trade or business which has been conducted for at least five years and which also had not been acquired during such period in a taxable transaction. These requirements seem rather simple but in actual practice complications can arise. My office is presently working to obtain a ruling, based upon the provisions of Section 346(a) of the Internal Revenue Code, on such a transaction and perhaps a description of the case will be of interest.

One of our clients is engaged in selling clothing, furniture, and household appliances at retail. This business is conducted to a large extent upon a time-payment basis although a fair part of such business is conducted for cash. The business has been conducted at several locations. The company has also engaged for many years in the business of renting real estate. Each business has been reasonably profitable in the past but in recent years the retail business has become more competitive and it has now become not sufficiently profitable.

The company has decided to terminate its merchandising activity and wishes to distribute the proceeds of liquidation of such activity to its stockholders in a type of transaction qualifying as a partial liquidation. It proposes to continue its rental business at its present level or at a greater level if it can find other suitable properties to acquire for such purposes.

We have encountered a number of problems in connection with this matter and a discussion of some of them may be of interest to you.

The normal operating assets of the merchandising business are cash, customers' receivables, inventories, and depreciable assets. As to the cash which may be available for distribution no problem exists except that it appears a fair allocation should be made of cash as between the merchandising and rental business. The customers' receivables are in an important amount and collections are being rapidly made, but owing to installment sales terms perhaps \$500,000 will not be collected by the end of the taxable year in which distribution must be made. It is impractical to distribute these receivables to the stockholders, so a method must be selected which meets the requirements of the law. Inventories have presented our greatest problem. The Regulations state that the inventories must be

distributed or sold in bulk and the proceeds distributed. Physical distribution of inventory is impractical, since it has a book value in excess of \$1,000,000. Attempts were made to arrange bulk sales but owing to the amounts in question no offers were received. The company negotiated with two auctioneers for a bulk sale but no reasonable offer was obtained. Finally the company chose to apply to the city for a special permit to conduct a liquidation sale. The permit was received, the sale consummated and we are now trying to show such sale was not in the ordinary course of business. It can be stated that the inventory problem is one of realization through contraction rather than one of distribution. Certain real estate has been used in the merchandising business and it is contemplated that some will be sold and some may be retained for the rental business. We are not yet sure that this can be done under the law and regulations but we believe it will be satisfactory. A minor problem also is presented in connection with life insurance upon the lives of several officers. The cash values to be received are about \$100,000 and we must consider whether this money properly represents proceeds from liquidation of the merchandising activity or must be prorated between the two businesses. We also have the problem of how much stock to retire. In a special ruling dated September 23, 1955 the Internal Revenue Service ruled that the portion of shares to be redeemed in a partial liquidation should be the ratio of assets distributed to total fair market value of all net assets. Since the retained assets are real properties held for a great many years how accurate must the determination of fair market value be?

DISTRIBUTION OF STOCK OF A CONTROLLED CORPORATION

It appears that still another method can be used to effect a redemption of stock under circumstances giving rise to ultimate capital gain treatment. This can be considered in cases where the corporation has operated more than one business and the stockholders wish to separate their interest, each being willing to continue one of the businesses. Section 355 of the Internal Revenue Code of 1954 offers a method to accomplish this. For example, in a proper case under this section, if corporation X operated two businesses and its stock was owned by A and B, the corporation could transfer the assets of one business to a new corporation Y and distribute the stock of Y to either A or B in exchange for the stock of X held by the party to the exchange. An important point to consider also is that in a proper case of this type no gain or loss is recognized at the date of exchange.

TREATMENT OF DISTRIBUTIONS

In the foregoing material an attempt has been made to describe the various ways in which distributions may be made for redemption of stock by a corporation. It now appears appropriate to summarize the tax effect upon the recipient and the distributor, the basis of the property received, and the effect of the distribution upon earnings and profits of the distributor. In discussing these points it will be assumed that amounts distributed have been determined to be fair and proper in relation to the stock concerned.

If the distribution in property is treated as a dividend, its basis to an individual is its fair market value. It is ordinary income to the extent it was derived from earnings and profits of the distributor corporation. Any excess is applied to the basis of the stock owned and after such basis is extinguished the remainder of the distribution is capital gain. If the entire distribution is treated as a dividend the stock of the corporation not surrendered takes the entire basis of the holding prior to surrender. In other words if stock is surrendered and the distribution is treated as a dividend no basis is lost if the distribution does not exceed the earnings and profits of the distributor corporation.

If the shareholder is a corporation the distribution is valued at the lesser of fair market value or its adjusted basis in the hands of the distributor corporation and the taxation result is the same as for an individual.

If the distribution qualifies as a redemption of stock the recipients are entitled to report the gain as capital gain. The effects of these distributions upon basis are as follows:

- If the distribution qualifies as a redemption under Section 302, the basis of the property received is its fair market value at date of distribution.
- If the distribution qualifies as a redemption under Section 303, the basis of the property received is its fair market value at date of distribution.
- If the distribution qualifies as a liquidation under Section 331, the basis of the property received is its fair market value at date of distribution.
- If the distribution qualifies as a liquidation under Section 332, the basis of the property received is the transferor's basis or as determined under Section 334(b)(2). However no gain or loss is recognized.
- If the distribution qualifies as a liquidation under Section 333, the

basis of the property received is computed in accordance with the provisions of that section.

- If the distribution qualifies as a liquidation under Section 337, the basis of the property received is the fair market value at date of distribution.
- If the distribution is made under the provisions of Section 304, the basis of property received will be determined as for a dividend or as for a redemption under Section 302.
- If the distribution qualifies as a partial liquidation under Section 346, the basis of the property received is its fair market value at date of distribution.
- If the distribution qualifies as a liquidation under Section 341, the basis of property received would be fair market value at date of distribution.
- If the distribution qualifies as a redemption under Section 355, the basis of the property received is the same as that of the property surrendered.

Generally no gain or loss results to a corporation making a distribution of property with respect to its stock. However, if a corporation distributes property representing unrealized installment obligations, lifo inventories, or property subject to a liability greater than the adjusted basis of such property, gain is recognized to the distributor corporation. If the distribution constitutes a partial or complete liquidation the adjustments regarding inventories and excess of liabilities over basis are not made. If it constitutes a complete liquidation under Section 332 the adjustment regarding installment obligations is not made. This matter is dealt with in Sections 311, 336, and 453(d) of the Internal Revenue Code of 1954.

Earnings and profits of the distributor corporation are subject to certain adjustments as provided in Section 312 of the Internal Revenue Code of 1954. If the distribution is treated as a dividend, the amount of money, the principal amount of obligations of the distributor, and the adjusted basis of other property distributed shall be charged to earnings and profits. If adjustments are required for lifo inventories, excess of liabilities over adjusted basis, and unrealized receivables under Section 311, the earnings and profits are increased by such adjustments and decreased by the lesser of fair market value of such assets or the earnings and profits after such increase. If the distribution constitutes a partial liquidation under Section 346 or redemptions under Section 302 or 303 earnings and profits shall not be reduced by the portions of such distributions properly chargeable to capital accounts.

CONCLUSION

It may be stated that methods still remain whereby earnings and profits may be in effect realized by a stockholder at the favorable capital gain rates. Some cases will be quite clear and the accountant will be certain of the result. In other cases there may be doubt as to the result and in such cases the safest procedure appears to be that of obtaining a ruling as to the results of the contemplated transaction before it is consummated.