**Problem Set #9 Stock Dividends**

* 1. Corporation X has outstanding: (i) 100 shares of one class of common stock – Alex (an individual) owns 50 shares and Bella (an individual) owns 50 shares and (ii) no preferred stock. In year 2, when Corporation X has no current earnings and profits and $100,000 of accumulated earnings and profits, Corporation X pays a stock dividend – distributing 1 share of non-voting, preferred stock on each share of outstanding common stock. The preferred stock is nonconvertible and limited and preferred as to dividends (in other words, dividends are paid on preferred stock before dividends are paid on common stock and the preferred stock, as a class, will at most receive a specified, limited return). Following the distribution, the fair market value of each share of preferred stock is $100, and the fair market value of each share of common stock is $100. Prior to the distribution, Alex and Bella each had a $120 basis in each share of common stock.
     1. Will Alex and Bella be subject to tax as a result of this stock dividend?
     2. Following the distribution, what will Alex’s and Bella’s basis in each share of common stock and each share of preferred stock be?
  2. Shortly after the stock dividend described above in (a), Alex sells all of his preferred stock to Claire for $100 per share. *Ignoring Section 306* and assuming Alex holds the preferred stock as a capital asset, how much tax liability will be incurred by Alex on the sale?
  3. Shortly after the sale described above in (b), Corporation X redeems all of the preferred stock held by Claire for $100 per share. Claire is not related to Alex or Bella within the meaning of Section 318. How much tax liability, if any, will be incurred by Claire on the redemption?
  4. If, instead of taking steps described in (a), (b) and (c) above, Corporation X had distributed $5000 cash to each of Alex and Bella in year 2, how much tax liability would be incurred by Alex as a result of the distribution, assuming that Alex is subject to 20% tax on any dividend income received from Corporation X?
     1. What if, instead, Alex was subject to 35% tax on any dividend income received from Corporation X?
  5. Could the tax consequences resulting from the transactions described above under (a), (b), and (c) also have been accomplished by distributing additional common stock as a stock dividend, Alex selling the new common stock to Claire, and Corporation X redeeming all of Claire’s common stock? What additional, non-tax risks would the use of common stock present?

1. In each of the following situations, is all or any portion of the stock distributed to Alex Section 306 stock? Why or why not?
   1. Corporation X has outstanding 100 shares of one class of common stock – Alex (an individual) owns 50 shares and Bella (an individual) owns 50 shares. In year 2, when Corporation X has no current earnings and profits and $100,000 of accumulated earnings and profits, Corporation X pays a stock dividend – distributing 1 share of common stock on each share of outstanding common stock. The fair market value of the common stock distributed is $5000, in total.
   2. Corporation X has outstanding: (i) 100 shares of one class of common stock – Alex (an individual) owns 50 shares and Bella (an individual) owns 50 shares and (ii) 10 shares of non-voting preferred stock owned by Claire. The preferred stock is nonconvertible and limited and preferred as to dividends (in other words, dividends are paid on preferred stock before dividends are paid on common stock and the preferred stock, as a class, will at most receive a specified, limited return). In year 2, when Corporation X has no current earnings and profits and $2000 of accumulated earnings and profits, Corporation X pays a stock dividend – distributing 1 share of preferred stock on each share of outstanding common stock and Corporation X also distributes cash to Claire. The fair market value of the preferred stock distributed on the common stock is $5000, in total.
   3. Corporation X has outstanding: (i) 100 shares of one class of common stock – Alex (an individual) owns 50 shares and Bella (an individual) owns 50 shares and (ii) no preferred stock. In year 2, when Corporation X has no current earnings and profits and no accumulated earnings and profits, Corporation X pays a stock dividend – distributing 1 share of non-voting preferred stock on each share of outstanding common stock. The preferred stock is nonconvertible and limited and preferred as to dividends (in other words, dividends are paid on preferred stock before dividends are paid on common stock and the preferred stock, as a class, will at most receive a specified, limited return). The fair market value of the preferred stock distributed is $5000, in total.
   4. Same as (c) except that, in Year 2, Corporation X has no current earnings and profits and $2000 of accumulated earnings and profits.
2. Two Individuals, Alex and Bella, organize X, an entity treated as a corporation, in 2000. Each contributed $10,000 cash in exchange for 100 shares of common stock. In July 2006, X declared a dividend payable in nonconvertible preferred stock: one share of the preferred stock for each share of common stock. Immediately after the distribution, the preferred stock had a fair market value of $200 per share and the common stock had a fair market value of $300 per share. On January 1, 2006, X had accumulated earnings and profits of $15,000, and X had $5,000 in current earnings and profits for 2006. On January 1, 2010, X had accumulated earnings and profits of $45,000, and X had $5,000 current earnings and profits for 2010. Determine the tax consequences of each of the following situations:
   1. In February 2010, Alex sold all his preferred stock to Parker, another individual, for $11,000.
   2. In February 2010, X redeemed all of Alex’s preferred stock for $11,000.
3. Answer the same questions set forth in question (3), assuming the facts are the same as described above except that, in 2010, X has no accumulated earnings and profits and $5,000 of current earnings and profits.