

# Chapter 9

## Taxation of Corporations

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### Solutions to Develop Research Skills

Note to Instructor: No research aids or “hints” are provided in the textbook for problems in this chapter. Before the solution to each problem, however, suggested research aids are provided. This allows you to choose whether or not to provide any hints to your students for a particular problem. For problems that can be solved using free Internet sources, you must provide students with the citations in these hints and refer students to Figure 2.2 in Chapter 2 of the text for the URLs to enable them to solve these problems using free Internet sources. Some of the problems require access to *Checkpoint®* or a similar service. The research process for solving a sample problem is illustrated in Appendix A through screen captures for *Checkpoint®*.

55. *Debt Characteristics (can be solved using free Internet sources)*

Locate and read Section 385 of the Internal Revenue Code and develop a comprehensive list of factors that indicate legitimate debt. What is the status of the regulations that are to expand on this Code section?

**Solution:** Factors to be considered in determining whether debt is legitimate as specified in Section 385 include: (1) Whether there is a written unconditional promise to pay on demand or on a specified date, a sum certain in money in return for an adequate consideration in money or money’s worth, and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

When Section 385 was written, Congress authorized the Service to issue clarifying regulations. However, there are no regulations that are applicable today. Regulations were issued at one time, but since then have been withdrawn.

56. *Property Dividends (can be solved using Checkpoint® or a similar service)*

Several years ago, Congress repealed the General Utilities Doctrine. Locate and read *General Utilities & Operating Co. v Helvering*, 296 U.S. 200 (1935). Summarize this case. What was the General Utilities Doctrine, and how did its repeal affect current transactions?

**Solution:** In the *General Utilities* case, the corporation distributed appreciated stock of another corporation as a dividend. The Board of Tax Appeals ruled in favor of General Utilities finding that the declaration and payment of the dividend resulted in no taxable income. The Commissioner, Helvering, appealed the case to the Fourth Circuit Court of Appeals. The appellate court reversed the prior ruling in favor of the Commissioner. The Supreme Court granted a writ of certiorari and held that the distributing corporation had no taxable income because the distribution was not a sale and the stock was not used to discharge a debt. This landmark case became known as the General Utilities Doctrine which allowed corporations to distribute appreciated property to their shareholders as a dividend without the recognition of income to the corporation. The General Utilities Doctrine was repealed in 1986. Since then, corporations have been required to recognize gain on the distribution of appreciated property to their shareholders for all distributions, including dividend distributions, redemptions, and liquidating distributions.

57. *Attribution (can be solved using free Internet sources)*

## 2 Taxation for Decision Makers Research Solutions

Locate and read Internal Revenue Code Sections 267, 318, and 544. Compare the definition of family in each of these sections.

**Solution:** Section 267(c)(4) defines family as an individual's brothers and sisters (whether whole or half blood), spouse, ancestors, and lineal descendants.

Section 318(a)(1) defines family as an individual's spouse, children, grandchildren, and parents.

Section 544(a)(2) defines family as an individual's brothers and sisters (whether whole or half blood), spouse, ancestors, and lineal descendants.

### 58. *Formation of Second Corporation (can be solved using Checkpoint® or a similar service)*

June owned all the stock of Corporation A. Over the years, the corporation had been very successful but had never paid any dividends, although it had substantial earnings and profits. June wanted to expand into another line of business as a sole proprietor but did not have the cash to do so. June decided to form B, a new corporation. She contributed all the stock of A to B. B borrowed \$100,000 from a bank using A stock as collateral. B then distributed all of its stock and the \$100,000 to June. How should June treat the distribution of the stock and the \$100,000?

Hint: Rev. Rul. 80-239, 1980-2 C.B. 103

**Issue:** How will the distribution of the stock and \$100,000 of money to June be treated for tax purposes?

**Conclusion:** The distribution of the stock will be tax free, but the distribution of the \$100,000 will be treated as a dividend to the extent of the earnings and profits of Corporation A.

**Discussion of Reasoning and Authority:** Rev. Rul. 80-239, 1980-2 C.B. 103 provides identical facts to those provided in this case. The ruling points out that Section 351(a) provides for no gain or loss recognition on the transfer of property to a corporation by one or more persons in exchange for stock of such corporation if, immediately after the transfer, the transferors are in control of the corporation. Section 351(b) also provides that Section 351 will apply even if something other than stock is received, but that gain may be recognized to the extent of the fair market value of the other property received. As such, Section 351(a) will apply to the transfer of the A stock to B in exchange for B's stock since June is in control of B immediately after the exchange. However, the nonrecognition provisions of Section 351 will not apply to the cash received by June. In the ruling, it was determined that the \$100,000 was in substance a disguised dividend from the old corporation to the individual. A distribution by the old corporation cannot be transformed for tax purposes into a distribution by the new company by using the latter as a conduit through which to pass the \$100,000. Thus, the individual will be treated as having received a \$100,000 dividend from the old corporation to the extent of the earnings and profits of Corporation A.