LESSON **5**

Dividends and Other Nonliquidating Distributions

5A General

GENERAL COMMENTS: Particularly if Lesson 4 on debt/equity has been skipped at this point, consider discussing generally the nondeductibility of dividends as compared with interest and the influence of that fact on LBOs and corporate behavior generally. See Lesson 4. Consider also contrasting the state law definition of dividends. Discuss the actual role of dividends in corporations today, vis-à-vis other methods of moving corporate income to equity owners (e.g., AT&T must pay dividends, but Mom & Pop, Inc., has other options; more to come on stock repurchase plans in lesson on redemptions). But 2003 legislation reducing the top tax rate on dividends to 15 percent (the same as capital gains) has significantly changed the tax stakes in this Lesson (tilting the scales far more favorably to dividend treatment than former law).

(1) Let's set out the basic operation of § 301 first. *A* realizes an amount distributed of \$200, of which *A* recognizes \$50 as a dividend. IRC §§ 301(a), 301(b)(1), 301(c)(1), and 316(a). The remaining \$150 of the distribution reduces *A*'s stock basis by \$100 to zero and *A* recognizes the final \$50 of the distribution as capital gain. IRC §§ 301(c)(2), 301(c)(3). The alternative produces the same result. Regs. § 1.301-1(m). Both the dividend and the capital gain are taxed at a top rate of 15 percent.

(2) Use this problem to show the role of E&P. Taxation of the prior year distributions would be inappropriate because the shareholders are just recovering their own capital contributions. In the current year, however, it is not so clear whether the distributions are from the shareholders' contributions or the earnings of *X*. Section 316(a) creates a presumption that the cash is from E&P (and thus a \$5 dividend to each) to the extent thereof, thus backloading stock basis. The alternative shows, however, that by buying basis (which should include the value of the pregnant distribution) in stock, a shareholder does not shield itself from income recognition on that dividend if the

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corporation has E&P; the characterization of a distribution as an includable dividend occurs solely at the corporate level on the basis of the corporation's E&P. This functions to ensure the double taxation of distributed corporate income. B&E ¶ 8.01.

(3) First, determine *X*'s current year taxable income (Regs. § 1.312-6(a)):

Gross income from business	$500
Dividend received	100
Capital gain	100
Total gross income	$700
Business expenses	($430)
§ 243(a)(1) dividend received deduction	(70)
§ 1211(a) capital loss	(100)
Total deductions	($600)
Taxable income § 63	$100

Second, "adjust" taxable income to derive "true economic earnings" to be used to distinguish return to shareholders of corporate capital from distributions of *X*'s earnings (i.e., E&P):

Increase taxable income by "real" income that was excluded:

Municipal bond interest (Regs. § 1.312-6(b))	$100

Reduce taxable income by recognized expenses/losses that were not allowed as deductions:

§ 162(e) expense	($90)
Excess capital loss [note that this loss was recognized but disallowed; therefore, § 312(f)(1) requires its recognition for E&P; contrast nonrecognition of deferred income in *Bangor*]	($46)
Accrued corporate income tax [Regs. § 1.312-6(a) says use same accounting method as for § 11; contrast cash-method corporation, *J.B. Ferguson*]	($34)

Increase taxable income by noneconomic deductions:

§ 243(a)(1)	$70
Net adjustments	$ 0

We should worry about whether § 312(k), § 312(m), or § 312(n) would require further adjustment. For example, if the business expenses include depreciation that is not straight-line or otherwise is denied for E&P purposes, § 312(k) may require use of a different depreciation schedule. Assuming there are no such adjustments, *X*'s current year E&P is $100, before taking into account the effect of any distributions to shareholders (the $100 amount may be referred to as "interim E&P." The fact that, in this problem, this amount is the same as taxable income is purely coincidental. (Note that the corporate income tax is not one of the E&P adjustments used in computing corporate AMTI.)

	Y	*A*	Total
§ 301(b)(1)	$100	$100	$200
§ 301(c)(1)	50	50	100
§ 301(c)(2)	50	40	90
§ 301(c)(3)	–	10	10
§ 1016(a)(4) ending *A*/*B* stock	50	0	–

Of the $200 distribution, $100 is a § 61(a)(7) dividend under § 316(a)(2). The lookback rule for the current year renders irrelevant the timing of the distribution on January 2, where there is current E&P and no accumulated positive or deficit E&P, as there is in this problem. The dividend portion is allocated half to each shareholder in proportion to the equal § 301(b)(1) amounts distributed to each. Regs. § 1.316-2(b). (*Y* will have a $40 deduction under § 243(c), if § 1059 applied, *Y* would have an ending stock basis of $10.) Because § 301(c)(3)(A) treats *A* as having a $10 gain from the "sale or exchange" of property (his stock, we must assume), *A* can report the gain as capital gain. *A*'s $50 dividend is taxed at the same rate as his $10 capital gain. *X* should be viewed as having an interim E&P of $100 that is reduced to (but not below) zero under § 312(a)(1) to yield an ending E&P of zero that becomes next year's accumulated E&P. B&E ¶¶ 8.02, 8.03, 8.04[1].

Consider discussing *W. Taylor Johnson* pattern: assume *A* had two blocks of stock with different bases. B&E ¶¶ 8.02[2], 8.02[5].

Variation: This simply reinforces the point that where we are dealing only with current E&P, the E&P is apportioned ratably to all distributions by amount thereof; therefore, *Y* would get $50 in dividends, and the four holders of *A*'s shares would get $12.50 each in dividends. B&E ¶ 8.02.

(4) Same answer as (3) because the "nimble dividend" may be paid from current E&P alone. IRC § 316(a)(2); B&E ¶ 8.02[3]. Note that if distributions were delayed until the next year (in which there is no current E&P), the accumulated and current E&P would be zero and there would be no dividend amount. In *Falkoff*, the sale of an asset (which would produce E&P) was delayed until the year following the distribution, which was funded by a loan secured by the asset, thus shielding the shareholders from dividend treatment.

We have assigned no problems involving an accumulated E&P deficit and sequential distributions or accumulated E&P and current losses. These can be discussed if the teacher deems appropriate (which may not be a wise move).

(5) Chart out chronologically the declaration date (December 1), record date (December 15), payment date (December 31), and actual receipt date (January 2). There are two main issues here: Which year is considered the "current year" for E&P purposes and in which year do the shareholders recognize whatever income they have from the distribution? The year in which the distribution or payment date falls is the current year for determining the "taxable status" of the dividend. Rev. Rul. 65-23. This also would be the date for valuing any in-kind distribution. Since the corporation is required to inform the shareholder what portion of the distribution is a dividend, no later date would be identifiable by the corporation, uniform or practical. Therefore, the dividend amounts, basis reductions, gain amount, and ending E&P would remain the same as in the answer to (3). B&E ¶ 8.04[2].

The year of income recognition by *Y* and *A* changes, however. Although the normal cash method and accrual-method rules would cause *Y* to accrue the income in the current year and *A* to receive the income in the next year, all taxpayers are put on the cash method for dividends by Regs. § 1.301-1(b), so both shareholders report the income in the next year. (This is why § 243 speaks in terms of dividends "received," normally a cash-method term.) Note that for purposes of Form 1099, *X* is allowed to assume mail receipt will not occur until the next year, so this distribution is not reported on the current year Form 1099. Rev. Rul. 64-290. But if shareholders could pick up the checks on December 31 or were otherwise in constructive receipt under cash-method

rules, then the income would be recognized in the current year. This is likely to be the case in a closely held corporation such as *X* under the basic assumptions of the lesson. B&E ¶ 8.04[2].

(6) This is a sale "dividends on." *A* recognizes $500 capital gain. *C* takes a $540 basis in the stock initially, recognizes $50 in dividends when the $100 distribution is received (because his ownership on the record date gives him both legal and tax ownership of the dividend), and adjusts his stock basis down to $490. There is a theoretical lurking loss of $50 in the stock, which should now be worth $440. B&E ¶¶ 8.04[2], 8.07[1]. Note that a corporate seller will want to sell after the record date (as in the alternative below) to enjoy the DRD; similarly a corporate buyer may want to buy before the record date, but the buyer will more likely be subject to § 1059, since the dividend occurred quickly after stock acquisition.

Alternative: If *Y* sells just after the record date for $440 ("ex dividend," assuming the record date is the stock exchange's ex dividend date), then prima facie *Y* has a $50 dividend when received (January 2, in this case) and a $340 capital gain on the stock sale. The additional $50 of the distribution cannot reduce stock basis, which was all used in computing the stock sale gain, so the $50 will be additional gain under § 301(c)(3); the same result could be reached by reducing the stock basis by $50 and increasing the sale gain by $50, except that the year of the $50 gain shifts.

Consider discussing a situation in which the ex dividend date is after the record date and the sale for $540 occurs between these two dates, so that the seller includes the dividend in gross income but the buyer actually gets it. In that case, seller *Y* has $100 dividend and $440 amount realized for purposes of computing gain realized—$340 on our facts. The buyer has a $440 basis in the stock and a $100 basis in the "dividend." Rev. Rul. 82-11; B&E ¶ 8.07[1]. Discuss *Caruth Corp.*, a surprising result in the close corporation setting. Also discuss other dividend-stripping techniques, such as those caught by § 1059(f).

(7) *A* formerly wanted to sell the stock for $6M in order to report the $5M gain as all capital gain, taxed at 20 percent. *A* did not want to take a $1M dividend, taxed then at 40 percent, and pay the capital gains rate on only $4M gain. But since 2003, dividends are taxed at the same rate as capital gains (the top rate is now 15 percent); since *A*'s tax would now be the same under either format, *B*'s wishes would probably prevail here—pay the reduced $5M price.

(8) *Y* wants a pre-sale dividend of $1M, and wants to claim the DRD, rather than pay the full corporate tax on that $1M as capital gain. When the seller is a corporation that will enjoy the DRD, as in this case, the Service has an active history of claiming that the dividend was part of the sales price. See ***Waterman***, ***TSN***, and ***Litton***. Absent the peculiar facts of ***Waterman***, *Y* likely will enjoy the DRD. B&E ¶ 8.07[2].

(9) *X* has no E&P because *X* always has been an S corporation. IRC § 1371(c)(1). The tax items of *X* pass through to the shareholders in their taxable year in which the *X* year ends. Since the shareholders are all on the calendar year, the pass-through is in the current year. The pass-through income could not be reduced for tax paid by *X* due to the capital gain because § 1374 cannot apply to the capital gain since *X* always has been an S corporation. Similarly, *X* could not incur a tax on passive income with respect to the AT&T dividends under § 1375 because *X* has no subchapter C E&P. Under § 1366, separately computed items would pass through to each shareholder as follows: bond interest, $50; capital gain, $50; probably § 162(e) expenses, $45; and capital losses, $73. These items retain their character under § 1366(b), as does the $170 in nonseparately computed ordinary income from operations, $85 each. Each item is apportioned equally between the shareholders on the per-share, per-day method of apportioning all items of § 1377(a). B&E ¶ 6.06.

Each shareholder's stock basis is increased by his share of the bond interest ($50), his share of the capital gain ($50), and his share of the nonseparately computed income ($85) for a total $185 increase. IRC § 1367(a)(1). Each shareholder's stock basis is decreased by the § 162(e) expenses ($45) and the capital losses ($73), totaling $118, for a net increase in each shareholder's stock basis of $67. IRC § 1367(a)(2). Thus, *Y* has an adjusted basis of $167 and *A* has $107. These stock basis adjustments for the year occur before any part of the year's distributions are applied against stock basis. A distribution of $100 to each shareholder within the year will decrease their bases to $67 and $7, without creating any additional income recognition. IRC § 1368; B&E ¶ 6.08.

Alternative: This presents several potential problems. First, the capital gain could be subject to § 1374 if the assets sold were held by *X* as a C corporation. (This will be discussed in detail in the lesson on liquidations.) Second, there could be a termination of the S election under § 1362(d)(3). The dividend and interest income and the capital gain on the stock sale, totaling $300, are "passive investment income" under 1362(d)(3)(C)(i). *X*'s gross receipts are $800. Thus, more than 25 percent of gross

receipts is passive investment income under § 1362(d)(3)(A)(i). If *X* has subchapter C E&P at year-end and the same scenario occurs for three years running, the S election will terminate. B&E ¶ 6.04[3]. Furthermore, if subchapter C E&P exists at year-end, *X* must pay a tax equal to 35 percent times $300 times 100/300, equaling $35. IRC § 1375; B&E ¶ 6.07[2].

To determine whether *X* has any subchapter C E&P at year-end, first determine the accumulated adjustments account addition for the year. This is the same as the aggregate stock basis increase, $134, less the exempt interest, for a net AAA of $34. IRC § 1368(e)(1)(A). The $200 distributions first reduce the AAA by $34, to zero (and to that extent are tax-free to *A* and *Y*), and then reduce the $100 E&P (and to that extent are $50 dividends apiece), and the remaining $33 apiece reduces the basis of each shareholder's stock. B&E ¶ 6.08[3]. Thus, there is no E&P at year-end, no § 1368 tax, no danger of termination of the S election this year, and no § 1375 tax.

5B Distributions in Kind and Constructive Distributions

(1) Section 311(b)(1) requires *X* to recognize $100 capital gain (and supplies the "sale" required for § 1222(3)), which increases *X*'s E&P by $100, under both §§ 312(b)(1) and 312(f)(1). *X* accrues a $34 tax liability on the gain, which results in a net interim E&P of $160. Each shareholder receives a distribution amount of $100 under § 301(b)(1), of which $80 is a dividend to each under § 301(c)(1). Each shareholder takes a $100 basis in the AT&T stock and starts a new holding period. IRC § 301(d); § 1223(2) does not apply to tack *X*'s holding period. *A*'s *X* stock basis is reduced to $20 and *Y*'s *X* stock basis is reduced to $80. *X*'s ending E&P (which also becomes *X*'s accumulated E&P) is zero, having been reduced by $200, but not going negative, under §§ 312(a)(3) and 312(b)(2). The unused E&P reduction of $40 is not carried over. B&E ¶¶ 8.21, 8.22.

Discuss prior § 1001(c) override by *General Utilities*, the *GU* doctrine's incorporation into the 1954 Code, and its gradual demise. B&E ¶ 8.20. Consider discussing the various efforts to evade *General Utilities* repeal and § 337(d)(1), and other *GU* repeal defense efforts. B&E ¶ 8.21[4].

Alternative: Even if *X* realizes a $20 loss, § 311(a) prevents recognition of the loss and it has no direct impact on E&P. Under § 312(a)(3), this distribution will decrease E&P

by the full $120 basis of the AT&T stock (but will not push E&P negative). B&E ¶ 8.22[2].

(2) *X*'s interim E&P still is $160. Under § 312(c), the downward adjustment is reduced by the liabilities, so the net E&P decrease is $100, leaving $60 accumulated E&P after the distributions. Under § 301(b)(2)(B), the amount of the distribution to each shareholder is $50, so *A* and *Y* each have a $50 dividend. B&E ¶¶ 8.21, 8.22. Under § 301(d), each shareholder takes a $100 adjusted basis in the property; here, FMV means gross (as in *Crane*), not net (as in § 301(b)); even if net, the shareholder "paid" the debt amount and should get a § 1012 cost basis step-up for that amount, yielding a total gross FMV basis. See B&E ¶ 10.04.

If the debt were $120 rather than $50 ($20 in excess of FMV), § 311(b)(2) would require *X* to realize $120 on each property and so recognize a total gain of $140, which § 312(f)(1) requires to be the amount of E&P increase. Note that § 312(b) does not so clearly yield this same result. See B&E ¶ 8.22[2]. Subtracting the corporate tax of $47.60 yields an interim E&P of $186.40. Under § 301(b), the shareholders would receive zero distributions. It would appear that the §§ 312(a) and 312(c) E&P decrease should be zero ($200 less $200 debt), leaving $186.40 in accumulated E&P. Shareholder basis for the distributed property under § 301(d) presumably is $100 (not $120); see Regs. § 1.1001-2. B&E ¶ 10.04.

(3) Under §§ 311(b) and 453B(a), *X* will recognize $100 and accrue a tax liability of $34. However, under § 312(n)(5), the E&P of *X* already has been adjusted for the installment sale gain, so the "E&P basis" for the notes should be equal to their face value, and the only further adjustment now is the $34 decrease, leaving $60 E&P, which gives *A* a $30 dividend, a $40 basis reduction, and a $30 gain. Note the extremely restricted availability of the installment method.

Because of § 301(e), however, solely for purposes of computing *Y*'s income, the installment method will apply (which on more complete facts would have decreased the accumulated E&P available for distributions to *Y*), so that the disposition of the notes will trigger a net E&P increase of $66, yielding $160 in current E&P, a dividend of $80 to *Y*, and a stock basis reduction of $20. *X*'s ending E&P for the current year is $60 less $200, or zero.

(4) First, ignoring OID, *X* recognizes no gain on the distribution of its own notes. IRC § 311(b)(1)(A). There is no E&P increase under § 312(b). There is an E&P decrease

of $240 under § 312(a)(2), assuming the issue price of each note is $120. Final accumulated E&P for the year will be zero. The distribution amounts to the shareholders will be $100, and each will have a $50 dividend and a $100 basis in the note. *Y*'s stock basis will reduce to $50 and *A*'s will reduce to zero; *A* will recognize a $10 gain. Under normal circumstances, the dividend is included in income on the receipt of the note and § 453 does not apply. Regs. § 1.301-1(1). As to *A*'s $10 gain, a question will arise as to the use of § 453. *Rufus Cox*, 78 TC 1021 (1982) held that § 453 did not apply, but § 453 has changed since then. B&E ¶¶ 8.02[5], 8.23.

Upon collection, and ignoring the TVM rules, each shareholder would have gross income of $20 under § 61(a)(3), which will be capital gain because § 1271(a)(1) supplies the "sale or exchange." Discuss how *Fairbanks* led to the adoption of the predecessor of § 1271(a)(1). B&E ¶ 4.21[1].

Second, taking OID into account, under § 1275(a)(4) distributed corporate debt is treated as if issued for property. Therefore, the issue price is the FMV of the debt on issuance—$100. IRC § 1273(b)(3); Regs. § 1.1273-2(b)(1). (Note that the application of the OID rules produces a smaller (here, $200 total) decrease in E&P under § 312(a)(2); otherwise, zero coupon debt with little value but a large face amount could clear out a large amount of E&P at little immediate dividend tax cost to the shareholder.) Under § 1273(a)(1), there is $20 OID per note. The shareholders and *X* will recognize interest income and deduction over the term of the notes under §§ 1272(a)(1) and 163(e)(1). Therefore, since the OID income recognition totaling $20 adjusts up the basis of the note to face amount by the time of collection, there is no gain left to be recognized upon collection, as incorrectly concluded above. B&E ¶ 4.42.

Third, if the notes are not publicly traded, the issue price is the same as the stated redemption price at maturity under § 1273(b)(4); therefore, there is no OID, since § 1274 does not apply because the notes bear adequate stated interest. However, there can be market discount on a debt acquired at original issue (as here), where the holder's basis is determined under § 1012. IRC § 1278(a)(1)(D)(ii)(I). Section 301(d) is analogous to § 1012. Therefore, upon collection the $20 spread probably is ordinary income and not capital gain. IRC §§ 1278(a)(2), 1276(a)(1). *X* has no deduction for market discount. B&E ¶ 4.44.

(5) *X*'s attempt to assign its income to the shareholders will fail and *X* will have $60 gross income. There is more than enough E&P to give shareholders a $30 dividend apiece from this constructive distribution. B&E ¶ 8.05.

(6) Because of the substantial disparity between payment and value, this is a distribution with respect to stock. *X* recognizes $100 gain under § 311(b), which produces an interim E&P of $160. E&P is reduced by $100 for the distribution because the $100 payment is like taking subject to a $100 debt under § 312(c), leaving $60 accumulated E&P. The amount of distribution each shareholder receives is the bargain element—$50. Regs. § 1.301-1(j); B&E ¶ 8.05[4]. Consider discussing *Alves* for a related § 83 issue.

Alternative: When *A* and *Y* pay more than FMV, perhaps hoping to create depreciation deductions (assume *X* has NOLs that will offset gain from the sale), there is no distribution by *X*. The shareholders, however, should take a $200 basis in the property and increase their aggregate stock basis by $100 for a contribution to capital under Regs. § 1.118-1. But cf. *Nestle Holdings*, B&E ¶ 13.23[3][e].

(7) If this transfer is truly for salary, then it is not with respect to *X*'s stock and is not a distribution under § 301(a). Thus, *X* has a § 1001 sale with $80 gain recognized and a $100 compensation deduction under § 83(h). *A* has $100 of gross income under § 83(a). If the salary is in excess of reasonable compensation, then the excess is not deductible but the entire amount is still income to *A*.

The word "salary" was in quotations because that characterization can be questionable between related taxpayers. If the transfer cannot be treated as even excessive salary, it must be a distribution with respect to stock, and *X* has § 311(b) gain of $80 but no deduction. *Truesdell* held that where such payment is not a "theft" from the corporation, and not salary, E&P must be present to support dividend treatment of the distribution. Note that Regs. § 1.162-8 seems to push ambiguous payments toward compensation, which probably would be the case here since *Y* got no proportionate distribution. B&E ¶¶ 8.05[3], 8.05[9]. Note also that this type of distribution would not kill an S election under the one-class-of-stock regulations. Regs. § 1.1361-1(*l*)(2)(v), Ex. (3).

The fear of excessive compensation often leads to agreements to repay compensation found to be excessive, like those in *Oswald*. *Oswald* held that such repayments are deductible when made. *Van Cleave* even allowed § 1341 to apply to such a payback. B&E ¶¶ 8.05[1], 8.05[2], 8.05[3].

Alternative: *X* has no income under Regs. § 1.1032-1(a). *X*'s E&P does not increase, since § 312(b) does not apply because, if the transaction really is for salary, this is not

a distribution. Section 312(f) also does not apply, because there is no gain recognized. *X* does have a $100 deduction under § 83(h), however, and, by analogy to a taxable stock dividend, E&P probably should be reduced by the same amount *A* includes in income—$100. IRC § 83(a); Regs. § 1.312-1(d).

If the preferred stock is really a stock dividend to *A* rather than salary, however, its taxability to *A* (and thus the E&P reduction) will be governed by § 305. Regs. § 1.312-1(d). Section 312(b) will not require an E&P increase because *X*'s stock is not property in "this part" (Part I of subchapter C) under § 317(a). B&E ¶ 8.40.

Discuss *Fender Sales* and how § 267(a)(2) somewhat cures the whipsaw of the fisc involved in that case.

(8) The Service might well assert that these advances were distributions from the outset. Discuss *Alterman Foods*. Discuss the possibility that if the loan is respected as such, § 7872 will apply. B&E ¶ 8.05[6].

(9) *X* recognizes $100 under § 311(b). $50 in capital gain passes through to each shareholder under § 1366, increasing *A*'s stock basis to $90 and *Y*'s stock basis to $150 under § 1367(a)(1). Each shareholder receives a distribution of $100 in amount under § 301(b), reducing *A*'s stock basis to zero and *Y*'s stock basis to $50 under §§ 1368(b) and 1367(a)(2)(A). *A* also recognizes $10 capital gain under § 1368(b)(2). B&E ¶¶ 6.06, 6.08.

If *X* is a converted C corporation, § 1374 can, of course, apply. Ignoring that, the $100 gain passes through, $50 to each, but also creates a $100 AAA account, which is reduced to zero by the distribution. *A* and *Y* recognize $50 dividend income each, and the E&P is eliminated. IRC § 1368(c). *A*'s ending stock basis is $40 and *B*'s ending stock basis is $100.

(10) The loss passes through under § 1366(a), $50 to each shareholder. *Y* is allowed to deduct the loss, and *Y*'s stock basis is reduced to zero. *A* is not allowed to deduct the loss because of § 1366(d)(1), because *A* has no stock or debt basis, unless *Selfe* controls to give *A* a $50 basis in deemed debt of *X* (*X* seems to be not credit worthy). B&E ¶ 6.06[4].

(11) Under Rev. Rul. 70-521 (which is out of date as to different treatment for corporate shareholders), the rights are considered property and the distribution of the rights would be a § 301 distribution at FMV, which might be zero on these facts.

However, it would seem that a two-year call has some value because of the locked-in price. The issues of whether and when §§ 311(b), 312(a), and 312(b) apply to *X* are unclear. It seems possible that (1) *X* recognizes § 311(b) gain equal to the excess of the value of the right over its zero basis; (2) such gain amount might be added to *X*'s basis in the *Y* stock; and (3) *X*'s E&P is reduced in that same amount at the time of distribution. Cf. Rev. Rul. 70-521. On the other hand, the general treatment of an option grant premium to the issuer is suspension of recognition until exercise or lapse. Rev. Rul. 58-234; B&E ¶ 4.62.

Upon a shareholder's sale of rights to a third party, the shareholder would recognize gain equal to the spread between the amount realized and his tax cost basis in the rights (equal to his distribution amount). See § 1234. Upon exercise, a shareholder would take a basis in the *Y* stock equal to the tax cost basis of his rights plus the $10 per share paid. Upon exercise, *X* will recognize $6 gain per *Y* share (or less, if *X*'s basis in the *Y* stock increases as suggested above), and *X*'s E&P should increase by that amount. It would not seem proper to reduce the E&P to reflect the premium value since E&P has never been increased to reflect that value. B&E ¶ 8.05[4]; *Palmer*, *Baumer*, and *Redding*.

Alternative: For treatment in the case of an option lapse without exercise, see § 1234 (generally, a capital loss to the holder and a short term capital gain to the grantor).

Note the possible planning use of Rev. Rul. 70-521 to shift future corporate-level appreciation out of corporate solution on a tax-free basis by "freezing" the distribution at earlier low values. Rev. Rul. 70-521 was written in a *General Utilities* world. Consider also poison pills. B&E ¶ 8.42[3].