EA Part 2
Study Unit 16

CORPORATE REDEMPTIONS AND LIQUIDATIONS

Gleim® EA Review

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Stock Redemption

A stock redemption occurs when a corporation acquires its stock from its shareholders in return for cash or property.

Redemption is treated as either:

- a **sale**
- an **exchange** or
- a **dividend**

Stock Redemption

Partial Liquidation

Noncorporate shareholders will receive sale or exchange treatment.

Liquidated

The corporation's shareholders will surrender all of their stock and receive their pro rata shares of any remaining assets after all creditors are paid.

Redemptions

Redeeming Stock

Stock is redeemed when a corporation acquires its own stock from a shareholder in exchange for property

- The redemption occurs regardless of whether the stock is canceled, retired, or held as treasury stock.
- A **shareholder** is required to treat the amount realized on a redemption (not in liquidation) as either:

  (1) a **distribution** (i.e. a corporate dividend) or

  (2) a **sale of the stock** redeemed.

Redemptions as Sales

Redemptions of stock - Treated as Dividends

Exception:

Qualifies for **sale** treatment (gains and losses are capital) if:

1. The redemption is not **essentially equivalent** to a dividend.
2. The redemption is **substantially disproportionate**.
3. The distribution is in **complete redemption** of all a shareholder's stock in the corporation.
4. The distribution is to a **non-corporate shareholder** in partial liquidation.
5. The distribution is **received by an estate**.

Redemption of all stock owned by shareholder treated as a distribution. Capital Gain = Distribution less Basis.

Two unrelated individuals, Ward and June, own all the stock of Wally Corporation, which has earnings and profits of $300,000. Because of his inactivity in the business for the last several years, Ward has decided to retire from the business completely and move to Oregon. Accordingly, Wally will redeem all the stock owned by Ward and, in return, Ward will receive a distribution of $450,000. Ward's adjusted basis in the stock is $250,000. What will be the tax effect to Ward?

A. $150,000 capital gain.

B. $300,000 dividend.

C. $450,000 dividend.

D. $200,000 capital gain.

Answer (D) is **correct**.

Under Sec. 302(b)(3), if a corporation redeems all of its stock owned by a shareholder, the redemption is treated as a distribution in partial payment or full payment in exchange for the stock. Since Wally Corporation redeemed all of Ward's stock, the $450,000 distribution is treated as payment for the stock, and any gain is treated as capital gain. The amount of the gain is computed under Sec. 1001 and is the amount by which the distribution exceeds the shareholder's basis in the stock. In this case, the gain is $200,000 ($450,000 distribution – $250,000 basis). Because the stock is a capital asset, the recognized gain is a capital gain. Because the distribution is treated as an exchange for the stock and not as a dividend, the amount of the corporation's earnings and profits is irrelevant. Earnings and profits affect distributions only when those distributions have the character of dividends.

Redemption is a dividend unless certain conditions apply.

With respect to the redemption of stock, which of the following tests does NOT establish that the redemption can be treated as an exchange of stock rather than as a dividend?

A. The redemption is substantially disproportionate with respect to the shareholder.

B. The redemption is not substantially equivalent to a dividend.

C. The redemption terminates the shareholder's entire interest in the corporation.

D. The redemption is of stock held by a corporate shareholder and is made in partial liquidation of the redeeming corporation.

Answer (D) is **correct**.
A redemption qualifies for sale or exchange treatment if the redemption is (1) substantially disproportionate, (2) a complete termination of the shareholder's interest, (3) not essentially equivalent to a dividend, (4) a partial liquidation of the distributing corporation in redemption of part or all of a noncorporate shareholder's stock, or (5) the distribution is received by an estate. A redemption of stock held by a noncorporate shareholder in a partial liquidation will receive sale or exchange treatment but not a redemption of stock held by a corporate shareholder.

Redemption of all corporate stock owned by a shareholder is treated as a sale. Capital gain or loss is recognized.

Gus Corporation, a C corporation, is owned equally by Al, Bill, and Charlie. Their stock basis on December 31 is as follows: Al $20,000, Bill $40,000, and Charlie $40,000. Gus Corporation has earnings and profits of $90,000 at the end of the calendar year and will continue as a viable entity. Al wants to exit the corporation and pursue other interests. He surrenders all his shares and receives $15,000. What are the tax consequences to Al of this complete redemption?

A. $5,000 capital loss.

B. $5,000 capital gain.

C. $15,000 ordinary dividend.

D. None of the answers are correct.

Answer (A) is **correct.**

Under Sec. 302(b)(3), if a corporation redeems all of its stock owned by a shareholder, the redemption is treated as a distribution in part or full payment in exchange for the stock. Since Gus Corporation redeemed all of Al's stock, the $15,000 distribution is treated as payment for the stock, and any loss is treated as capital loss. The amount of the loss is computed under Sec. 1001 and is the amount by which the distribution is less than the shareholder's basis in the stock. Because the distribution is treated as an exchange for the stock and not as a dividend, the amount of the corporation's earnings and profits is irrelevant. Earnings and profits affect distributions only when those distributions have the character of dividends. In this case, the loss is $5,000 ($15,000 distribution – $20,000 basis). Additionally, since the stock is a capital asset, the recognized loss is a capital loss.

Corporate Recognition

Gain Recognized at Fair Market Value

A corporation recognizes gain realized on a distribution as if the property distributed were sold at fair market value to the distributee immediately prior to the distribution, even if stock is redeemed by the distribution.

Ordinary Income recognized on Depreciated Property

A corporation recognizes ordinary income on the distribution of depreciated property to the extent of depreciation or amount realized, whichever is less.

Corporate Recognition

No Recognition of Loss Realized

No recognition of loss realized is allowed the corporation, unless:

- the redemption is in complete liquidation of the corporation
  - or -
- of stock held by an estate (to pay death taxes).

Shareholder Recognition

A shareholder treats a non-qualifying redemption in the same manner as a regular distribution.

- A qualifying redemption is treated as a sale or exchange
- The amount is a dividend to the extent of E&P.
- Any unrecovered basis in the redeemed stock is added to the shareholder's basis in stock retained.
- A distribution that redeems all of a shareholder's shares is treated as a sale irrespective of earnings and profits.

Reacquisition of Stock

Reacquisition Expenses Not Deductible

- Expenses incurred in connection with any reacquisition by a corporation of its own stock or the stock of a related person (under the 50% relationship test) are not deductible.
- An exception exists for any cost allocable to an indebtedness and amortized over the life of the indebtedness (such as financial advisory costs).

Example: Shareholder Treatment – Nonqualifying Redemption of Stock

Since 2017, Paige has owned all 1,010 outstanding shares of E and E Corporation's stock. Paige's basis for the stock is $10,100.

In 2023, E and E has earnings and profits of $110,000. The corporation redeemed 450 shares of Paige's stock for $98,000 in 2023.

How is the redemption treated?

Because Paige owns 100% of the stock before and after the redemption, the transaction is a dividend to the extent that E and E has earnings and profits. Because the distribution ($98,000) is less than earnings and profits ($110,000), the entire amount is taxable as a dividend.

Sale Treatment

The shareholder treats qualifying redemptions as if the shares redeemed were sold to a third party.

Gain or loss

the difference between the fair market value of the property received and the adjusted basis of the shares.

Character of gain or loss

depends on the nature of the stock in the shareholder’s hands.

Basis

its fair market value.

Sale Treatment

The shareholder treats qualifying redemptions as if the shares redeemed were sold to a third party.

Holding period for the property

starts the day after the redemption.

Separate Treatment of a redemption as a sale

determined separately for each shareholder

Sale Treatment

The shareholder treats qualifying redemptions as if the shares redeemed were sold to a third party.

applies only to redemptions that

(1) terminate a shareholder’s interest;

(2) are substantially disproportionate between shareholders;

(3) are not essentially equivalent to a dividend;

(4) are received by an estate; and

(5) are from a shareholder, other than a corporation, in partial liquidation.

Where the shareholder owned 100% of the Corporate stock before and after the distribution, it is considered a dividend to the extent of the corporation's profits and losses

A stock redemption is the acquisition by a corporation of its stock from a shareholder. A shareholder who owns all of the stock of a corporation sells back one half of his stock for cash. Assume that the current E&P is greater than the redemption amount. Which of the following statements is true with regard to this stock redemption?

A. This sale back to the corporation of one half will cause no percentage change in the shareholder's ownership.

B. After the redemption the shareholder will own all of the stock in the corporation.

C. The stock redemption resembles a dividend distribution and will be taxed accordingly.

D. All of the answers are correct.

Answer (D) is **correct**.
Stock is redeemed when a corporation acquires its own stock from a shareholder in exchange for property. The redemption occurs whether or not the stock is canceled, retired, or held as treasury stock. A shareholder is required to treat amounts realized on a redemption (not in liquidation) either as a distribution (a corporate dividend) or as a sale of the stock redeemed. Because the shareholder owns 100% of the stock before and after the redemption, the transaction is a dividend to the extent that the corporation has earnings and profits.

Not Essentially Equivalent

Definition

Not essentially equivalent to a dividend means that there is a meaningful reduction in the shareholder’s proportionate interest in the corporation.

Not Essentially Equivalent

Reduction in voting power is required for a redemption

- Shareholders in control of a corporation must generally **lose control** to qualify as not essentially equivalent to a dividend.
- Majority control (over 50%) reduction to deadlock (50%) has been determined sufficient.
- Minimal reduction by a minority shareholder may be meaningful.
- Attribution can be used to determine essential equivalence.

Substantially Disproportionate

Definition

the amount received by shareholders is not in the same proportion as their stock holdings.

Test

It is tested by determining the shareholders' applicable ownership percentages (including constructive ownerships) both before and after the redemption.

Substantially Disproportionate

Shareholder Ownership

A redemption is substantially disproportionate with respect to a shareholder if, immediately after the redemption, the shareholder owns

- Less than 50% of the voting power of outstanding voting stock and
- Less than 80% each of interest in
  - The voting stock owned before the redemption and
  - The common stock owned before redemption.

Substantially Disproportionate – Example

Carol, an individual shareholder, owns 275 shares of Allegiance Corporation. Allegiance has 1,000 shares of common stock outstanding and redeems 200 shares of common stock from its shareholders.

What is the least number of Carol's shares that will need to be redeemed in order for the redemption to be substantially disproportionate to Carol?

Substantially Disproportionate – Example

1. **Determine percentage of shares owned by Carol:**

   275 shares / 1,000 shares = 27.5%

2. **Determine 80% substantially disproportionate amount:**

   22% interest = 80% x 27.5%

3. **Determine maximum shares amount after redemption**

   176 shares = 22% interest x (1,000 shares – 200 shares)

4. **Determine how many shares need to be redeemed**

   More than 99 shares (275 shares – 176 shares) need to be redeemed to reduce Carol's interest below 22%.

5. **Result**

   Carol needs to have a minimum of 100 shares redeemed for the redemption to be substantially disproportionate.

Termination

Qualification

Termination of a shareholder's interest must be complete

- **All the stock** in the corporation owned by the shareholder, actually and through family attribution, must be redeemed in the exchange for property.

Termination

Family Attribution Rules

May be waived if the following three requirements are met:

1. Shareholder may not retain any interest in the corporation, except as a **creditor**.
2. Shareholder may not **acquire an interest for 10 years**, except by bequest or inheritance.
3. A **written agreement** must be filed with the IRS stating that the IRS will be notified if a prohibited interest is acquired.

Treatment by Estates

An estate may treat a qualifying redemption (to pay death taxes) as a sale.

- Redeemed stock must be valued at more than 35% of the gross estate, net of deductions allowed.
- Deductions allowed are administration expenses, funeral expenses, claims against the estate, and unpaid mortgages.

Constructive Ownership

The (redeemed) shareholder is treated as owning shares by related parties:

- **Relatives** - Stock owned, directly or indirectly, by or for the shareholder’s spouse, children, grandchildren, or parents (excludes siblings and grandparents)
- **Partnership** - Stock owned, directly or indirectly, by or for a partnership (or an S corporation) in which the shareholder is a partner. The reverse also applies.
- **Estate** - Stock owned, directly or indirectly, by an estate or trust in which the shareholder is treated as a beneficiary or owner
- **Corporation** - Stock owned, directly or indirectly, by or for a corporation (other than an S corporation) in which the shareholder owns, directly or indirectly, at least 50% of the value of the stock
- **Buy Option** - Stock on which the shareholder holds an option to buy

Constructive Ownership - Example

A Corporation has 100 shares outstanding. A husband, wife, child, and grandparent (the child's child) each own 25 shares. How many shares are each considered to own?

Husband, wife and child are each considered as owning 100 shares.

The grandchild is considered as owning only 50 shares (25 shares of the grandchild + 25 shares of the child)

Form 1099-DIV must be provided to recipients for whom the payer has paid $600 or more as part of the liquidation.

Annual statement Form 1099-DIV must be furnished to recipients of which of the following?

A. Liquidating distributions of $600 or more.

B. Patronage dividends.

C. Both liquidating distributions of $600 or more and patronage dividends.

D. None of the answers are correct.

Answer (A) is **correct.**
A Form 1099-DIV must be provided to recipients who have received dividends (including capital gains dividends) and other distributions on stock of $10 or more, recipients for whom the payer has withheld and paid any foreign tax on dividends and other distributions on stock, recipients for whom the payer has withheld any federal income tax under the backup withholding rules, and recipients for whom the payer has paid $600 or more as part of a liquidation. Patronage dividends are reported on Form 1099-PATR.

EA Part 2
SUBUNIT 16.2

Complete Liquidation

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Complete Liquidation

Definition

A corporation redeems all of its stock in a series of distributions

Gains and Loss Recognized at FMV

The corporation recognizes any gain or loss realized on distributions in complete liquidation as if the property were sold at its **fair market value** to the shareholder immediately before distribution.

Complete Liquidation

Gain or loss computed

On an asset-by-asset basis.

Fair market value of distributed property

Treated as not less than the related liabilities the shareholder assumes or to which the property is subject.

Character of amounts recognized

Depends on the nature of the asset in the hands of the distributing corporation.

Complete Liquidation – Corporate Gains

Under a plan of complete liquidation, Zaige Corp distributed land having an adjusted basis to Zaige of $19,000 to its sole shareholder. The land was subject to a liability of $98,000, which the shareholder assumed for legitimate business purposes.

The FMV of the land on the date of distribution was $71,000. What is Zaige's recognized gain?

Generally, the FMV of $71,000 would be used to determine any gain. However, because the liability relief of $98,000 is greater than FMV, Zaige's recognized gain is $79,000 ($98,000 liability relief - $19,000 adjusted basis)

Gain is recognized on the distribution of appreciated property as if it had been sold (capital).

In Year 1, pursuant to a complete liquidation, Richards Corporation distributes the following to a shareholder: inventory, basis $10,000, FMV $20,000; and land held as an investment, basis $5,000, FMV $40,000. The land is subject to a $30,000 liability. What are the amounts and character of income to be recognized by Richards Corporation?

A. $10,000 ordinary income; $35,000 capital gain.

B. $10,000 ordinary income; $65,000 capital gain.

C. $0 ordinary income; $0 capital gain.

D. $10,000 ordinary income; $5,000 capital gain.

Answer (A) is **correct.**
Section 311(b) requires that gain on the distribution of appreciated property be recognized as if the property had been sold. Therefore, Richards Corporation recognizes $10,000 as ordinary income for the inventory ($20,000 FMV – $10,000 basis) and $35,000 as capital gain for the land ($40,000 FMV – $5,000 basis). The $30,000 liability is irrelevant when considering the corporate gain. If the liability exceeds the FMV of the property, however, the liability amount would be considered the new “selling price” and shareholder basis in the property.

Corporate Losses

A corporation generally recognizes any losses realized on liquidating distributions.

- Certain realized losses are **not recognized** when the distributee shareholder is **related** to the corporation.
- A more-than-50% shareholder, actually or constructively, is a related distributee.
- The amount of a loss inherent on a contribution reduces the loss recognized on distribution.

Gain or loss is recognized on a liquidating distribution of assets. If distribution is to a related party, loss is not recognized, unless property is distributed to all shareholders on a pro rata basis and the property was not acquired or was contributed capital in previous 5 years.

Individual Y owns 55% of Beta Corporation. Five years ago, Y contributed property with an adjusted basis of $20,000 and a fair market value of $8,000 to Beta in a transaction qualifying under Sec. 351. In the current year, Beta adopted a plan of complete liquidation and distributed this same property to Y. At this time, the property had an adjusted basis of $18,000 and a fair market value of $5,000. How much loss will Beta recognize on the distribution?

A. $0

B. $1,000

C. $12,000

D. $13,000

Answer (A) is **correct**.
Normally gain or loss is recognized on a liquidating distribution of assets [Sec. 336(a)]. However, under Sec. 336(d)(1), a loss is not recognized in a liquidation on the distribution of property to a related person (which includes a greater-than-50% shareholder) unless the property is distributed to all shareholders on a pro rata basis and the property was not acquired in a Sec. 351 transaction or contribution to capital during the 5 preceding years (also known as disqualified property). Since the distribution was of property acquired in a Sec. 351 transaction within the 5 preceding years, no loss is recognized on the distribution of the disqualified property to the related person. The fact that the distribution was not pro rata does not affect the ability to recognize the loss.

Shareholder Treatment

A shareholder treats amounts distributed in complete liquidation as realized in exchange for stock.

- **Capital recovery** - to the extent of basis is permitted before recognizing gain or loss.
- **The holding period -** will not include that of the liquidated corporation.
- **Amounts realized -** include money and the fair market value of other distributed property received.
- **Liabilities assumed or to which property is subject -** reduce the amount realized.
- **Allocation of amounts realized -** to each block of stock is required.

Shareholder Recognition

When a series of liquidating distributions is made, the shareholder must use the cost-recovery method for recognition of gain or loss.

- Each payment received is first applied against the basis of the stock.
- When basis is exceeded, a gain must be recognized.
- The character of recognized gain or loss depends on the nature of each block of the stock in the hands of the shareholder.
- The basis in distributed property is its fair market value, but only after gain or loss on its receipt has been recognized.

Expenses from Liquidation

Expenses incurred in connection with the liquidation are deductible by the dissolved corporation.

Liquidating Distribution to Shareholder

A single distribution to Shareholder R on February 1, 2023 of $70 cash and a car (FMV $25), subject to a liability of $15.

What is the amount realized by R?

R's amount realized is $80, [$70 + ($25 - $15)]

Liquidating Distribution to Shareholder - Example

If Held stock for investment

- **Block A: Recognize LTCG**
- **Block B: Recognize LTCL**

Block	Shares	Acquired	Basis	Amount Realized	Gain (Loss) Realized
A	1	5/10	$10	$20	$10
B	3	10/16	$90	$60	$(30)

EA Part 2

SUBUNIT 16.3

Partial Liquidation

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Partial Liquidation

A noncorporate shareholder treats a distribution as a sale to the extent it is (in redemption) in partial liquidation of the corporation.

- The corporation making the distribution recognizes gain but not loss.
- A corporation receiving a distribution in redemption for partial liquidation of another corporation treats the distribution as a dividend to the extent of E&P of the distributing corporation.
- The distributee corporation is eligible for the dividends-received deduction.

Where a corporation makes a distribution of property to a noncorporate shareholder in partial liquidation, the distribution is treated as being in exchange for stock. Realized gain = FMV less basis.

Oak Corporation had earnings and profits of $500,000 before distributions. Due to economic conditions, Oak, in partial liquidation, distributed land having an adjusted basis to Oak of $135,000 and a fair market value of $150,000 to Mr. Brown for 95% of his interest in Oak Corporation. Mr. Brown's adjusted basis in the stock at the time of the distribution was $180,000. What is the amount of Oak Corporation's recognized gain or loss?

A. $(45,000)

B. $(30,000)

C. $0

D. $15,000

Answer (D) is **correct**.
If a corporation makes a distribution of property to a noncorporate shareholder in partial liquidation, the distribution is treated as being in exchange for stock. Since the corporation makes a distribution of property whose fair market value ($150,000) exceeds its basis ($135,000), the corporation will recognize a gain of $15,000 as if it had sold the property to the shareholder at its fair market value.

A redemption of an interest held by a noncorporate shareholder made in partial liquidation of the corporation is treated as a distribution in exchange for the stock.

Ivana Dolla received property with a fair market value of $60,000 and an adjusted basis of $33,000 from Candid Corporation in partial liquidation. Candid's earnings and profits for the year prior to the distribution were $250,000. Ms. Dolla's basis in the stock she exchanged was $44,000. What is the amount of Ms. Dolla's recognized gain?

A. $11,000

B. $16,000

C. $27,000

D. $60,000

Answer (B) is **correct**.
Under Sec. 302(b)(4), a redemption of an interest held by a noncorporate shareholder made in partial liquidation of the corporation is treated as a distribution in exchange for the stock. The shareholder will treat any gain on the redemption as a capital gain. The amount of the gain is computed under Sec. 1001. Under Sec. 301(b)(1), the amount of the distribution is the fair market value of the property. Ms. Dolla will recognize a gain of $16,000 on the distribution ($60,000 fair market value of the distributed property – $44,000 basis in the stock).

Partial Liquidation

Refers to contraction of corporation's business. It must be pursuant to a plan, and the distribution must not be essentially equivalent to a dividend.

- The focus is not on the shareholders, but on a genuine reduction in size of the corporation's business
- The partial liquidation must be completed within either the tax year of plan adoption or the following tax year.
- Pro rata distributions do not preclude partial liquidation sale treatment.
- Shareholders are not required to surrender stock to the corporation.

Noncorporate shareholders who receive redemptions in partial liquidation may treat the distribution as payment for their stock. Any gain on the redemption is eligible for capital gain treatment.

Rachel purchased 100 shares of Comet Corporation stock for $500 in Year 1. In Year 4, Rachel received $5,000 in a distribution from the partial liquidation of Comet Corporation. On her personal Year 4 income tax return, Rachel must report income from this transaction as

A. Dividends.

B. Capital gains.

C. Other.

D. None of the answers are correct.

Answer (B) is **correct**.
Section 302(b)(4) allows noncorporate shareholders who receive redemptions in partial liquidation to treat the distribution as payment for their stock. Any gain on the redemption is eligible for capital gain treatment.

Safe Harbor

Noncorporate shareholders apply partial liquidation sale treatment to distributions received if these conditions are satisfied:

- ✓ The distribution is attributable to the corporation's **ceasing to conduct a trade or business** that it actively conducted for at least 5 years ending with the date of the distribution, and
- ✓ Immediately after the distribution, the corporation continues to conduct **at least one active trade or business** it has conducted for at least 5 years.