

Chapter 18

Corporations: Distributions Not in Complete Liquidation

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Taxable Dividends

- Distributions from corporate earnings and profits (E & P) are treated as a dividend distribution, taxed as ordinary income
- Distributions in excess of E & P are nontaxable to extent of shareholder's basis (i.e., a return of capital)
- Excess over basis is capital gain

Earnings & Profits

(slide 1 of 2)

- No definition of E & P in Code
- Similar to Retained Earnings (financial reporting), but often not the same

Earnings & Profits

(slide 2 of 2)

- E & P represents:
 - Upper limit on amount of dividend income recognized on corporate distributions
 - Corporation's economic ability to pay dividend without impairing capital

Calculating Earnings & Profits

(slide 1 of 4)

- Calculation generally begins with taxable income, plus or minus certain adjustments
 - Add previously excluded items back to taxable income including:
 - Muni bond interest
 - Excluded life insurance proceeds
 - Federal income tax refunds
 - Dividends received deduction

Calculating Earnings & Profits

(slide 2 of 4)

- Calculation generally begins with taxable income, plus or minus certain adjustments (cont'd)
 - Subtract certain nondeductible items:
 - Related-party and excess capital losses
 - Expenses incurred to produce tax-exempt income
 - Federal income taxes paid
 - Key employee life insurance premiums
 - Fines and penalties

Calculating Earnings & Profits

(slide 3 of 4)

- Certain E & P adjustments shift effect of transaction to year of economic effect, such as:
 - Charitable contribution carryovers
 - NOL carryovers
 - Capital loss carryovers

Calculating Earnings & Profits

(slide 4 of 4)

- Other adjustments
 - Accounting methods for E & P are generally more conservative than for taxable income, for example:
 - Installment method is not permitted
 - Alternative depreciation system required
 - Percentage of completion must be used (no completed contract method)

Summary of E & P Adjustments

Effect on taxable income for E & P:

<u>Transaction</u>	<u>Add</u>	<u>Subtract</u>
Tax-exempt income	X	
Life insurance proceeds	X	
Deferred installment gain	X	
Excess charitable contribution		X
Ded. of prior excess contribution	X	
Federal income taxes		X
Officer's life insurance premium		X
Accelerated depreciation	X	

Current vs Accumulated E & P

(slide 1 of 3)

- Current E & P
 - Taxable income as adjusted

Current vs Accumulated E & P

(slide 2 of 3)

- Accumulated E & P
 - Total of all prior years' current E & P as of first day of tax year, reduced by distributions from E & P

Current vs Accumulated E & P

(slide 3 of 3)

- Distinction between current and accumulated E & P is important
 - Taxability of corporate distributions depends on how current and accumulated E & P are allocated to each distribution made during year

Allocating E & P to Distributions

(slide 1 of 3)

- If positive balance in both current and accumulated E & P
 - Distributions are deemed made first from current E & P, then accumulated E & P
 - If distributions exceed current E & P, must allocate current and accumulated E & P to each distribution
 - Allocate current E & P pro rata to each distribution
 - Apply accumulated E & P in chronological order

Allocating E & P to Distributions

(slide 2 of 3)

- If current E & P is positive and accumulated E & P has a deficit
 - Accumulated E & P IS NOT netted against current E & P
 - Distribution is deemed to be taxable dividend to extent of positive current E & P balance

Allocating E & P to Distributions

(slide 3 of 3)

- If accumulated E & P is positive and current E & P is a deficit, net both at date of distribution
 - If balance is zero or a deficit, distribution is a return of capital
 - If balance is positive, distribution is a dividend to the extent of the balance

Cash Distribution Example

A \$20,000 cash distribution is made in each independent situation:

	<u>1</u>	<u>2</u>	<u>3*</u>
Accumulated E & P, beginning of year	100,000	(100,000)	15,000
Current E & P	50,000	50,000	(10,000)
Dividend:	20,000	20,000	5,000

*Since there is a current deficit, current and accumulated E & P are netted before determining treatment of distribution.

Property Dividends

(slide 1 of 4)

- Effect on shareholder:
 - Amount distributed equals FMV of property
 - Taxable as dividend to extent of E & P
 - Excess is treated as return of capital to extent of basis in stock
 - Any remaining amount is capital gain

Property Dividends

(slide 2 of 4)

- Effect on shareholder (cont'd):
 - Reduce amount distributed by liabilities assumed by shareholder
 - Basis of distributed property = fair market value

Property Dividends

(slide 3 of 4)

- Effect on corporation:
 - Corp. is treated as if it sold the property for fair market value
 - Corp. recognizes gain, but not loss
 - If distributed property is subject to a liability in excess of basis
 - Fair market value is treated as not being less than the amount of the liability

Property Dividends

(slide 4 of 4)

- Effect on corporation's E & P:
 - Increases E & P for excess of FMV over basis of property distributed
 - Reduces E & P by FMV of property distributed (or basis, if greater) less liabilities on the property
 - Distributions of cash or property cannot generate or add to a deficit in E & P
 - Deficits in E & P can arise only through corporate losses

Property Distribution Example

Property is distributed (corporation's basis = \$20,000) in each of the following independent situations. Assume Current and Accumulated E & P are both \$100,000 in each case:

	1	2	3
Fair market value of distributed property	60,000	10,000	40,000
Liability on property	-0-	-0-	15,000
Gain(loss) recognized	40,000	-0-	20,000
E&P increased by gain	40,000	-0-	20,000
E & P decrease on dist.	60,000	20,000	25,000

Constructive Dividend

(slide 1 of 2)

- Any economic benefit conveyed to a shareholder may be treated as dividend for tax purposes, even though not formally declared
 - Need not be pro rata

Constructive Dividend

(slide 2 of 2)

- Usually arises with closely held corporations
- Payment may be in lieu of actual dividend and is presumed to take form for tax avoidance purposes
- Payment is recharacterized as a dividend for all tax purposes

Examples of Constructive Dividends (slide 1 of 3)

- Shareholder use of corporate property (e.g., company car to non-employee shareholder)
- Bargain sale of property to shareholder (e.g., sale for \$1,000 of property worth \$10,000)
- Bargain rental of corporate property

Examples of Constructive Dividends (slide 2 of 3)

- Payments on behalf of shareholder (e.g., corporation makes estimated tax payments for shareholders)
- Unreasonable compensation

Examples of Constructive Dividends (slide 3 of 3)

- Below market interest rate loans to shareholders
- High rate interest on loans from shareholder to corporation

Avoiding Unreasonable Compensation

- Documentation of the following attributes will help support payments made to an employee-shareholder:
 - Employee's qualifications
 - Comparison of salaries with dividends made in past
 - Comparable salaries for similar positions in same industry
 - Nature and scope of employee's work
 - Size and complexity of business
 - Corporation's salary policy for other employees

Stock Dividends (slide 1 of 2)

- Excluded from income if pro rata distribution of stock, or stock rights, paid on common stock
 - Five exceptions to nontaxable treatment deal with various disproportionate distribution situations
- Effect on E & P
 - If nontaxable, E & P is not reduced
 - If taxable, treat as any other taxable property distribution

Stock Dividends (slide 2 of 2)

- Basis of stock received
 - If nontaxable
 - If shares received are identical to shares previously owned, basis = (cost of old shares/total number of shares)
 - If shares received are not identical, allocate basis of old stock between old and new shares based on relative fair market value
 - Holding period includes holding period of formerly held stock
 - If taxable, basis of new shares received is fair market value
 - Holding period starts on date of receipt

Stock Rights (slide 1 of 2)

- Tax treatment of stock rights is same as for stock dividends
 - If stock rights are taxable
 - Income recognized = fair market value of stock rights received
 - Basis = fair market value of stock rights
 - If exercised, holding period begins on date rights are exercised
 - Basis of new stock = basis of rights plus any other consideration given

Stock Rights (slide 2 of 2)

- If stock rights are nontaxable
 - If value of rights received $< 15\%$ of value of old stock, basis in rights = 0
 - Election is available which allows allocation of some of basis of formerly held stock to rights
 - If value of rights is 15% or more of value of old stock, and rights are exercised or sold, must allocate some of basis in formerly held stock to rights

Corporate Distribution Planning

(slide 1 of 2)

- Maintain ongoing records of E & P:
 - Ensures return of capital is not taxed as dividend
 - No statute of limitations on E & P, so IRS can redetermine at any time
 - Accurate records minimize this possibility

Corporate Distribution Planning

(slide 2 of 2)

- Adjust timing of distribution to optimize tax treatment:
 - If accumulated E & P deficit and current E & P loss, make distribution by end of tax year to achieve return of capital
 - If current E & P is likely, make distribution at beginning of next year to defer taxation

Avoiding Constructive Dividends

(slide 1 of 2)

- Structure transactions on “arms’ length” basis:
 - Reasonable rent, compensation, interest rates, etc...

Avoiding Constructive Dividends

(slide 2 of 2)

- Use mix of techniques to “bail out” corporate earnings such as:
 - Shareholder loans to corporation
 - Salaries to shareholder-employee
 - Rent property to corporation
 - Pay some dividends
- Overdoing any one technique may attract attention of IRS

Redemptions (slide 1 of 3)

- Transaction: corporation purchases its stock from shareholder
- If qualified as a redemption, from shareholder perspective, same result as a sale to a third party:
 - Shareholder has cash or other property instead of stock
 - Shareholder has less control over (ownership of) corporation

Redemptions (slide 2 of 3)

- From other shareholders' perspective, redemption does not resemble sale to third party:
 - Less stock is outstanding, so other shareholders' ownership percentage is increased

Redemptions (slide 3 of 3)

- From corporate view, does not resemble sale to third party:
 - Corporation has less assets, because some of these assets have been transferred to the shareholder redeeming stock

Effect of Redemption

(slide 1 of 3)

- If qualified as a redemption:
 - Shareholder reports gain or loss on surrender of stock
 - Gain taxed at favorable capital gains rates
 - Shareholder reduces gain by basis in stock redeemed

Effect of Redemption

(slide 2 of 3)

- If transaction has appearance of a dividend, redemption will not be qualified:
 - For example, if shareholder owns 100% and corporation buys $\frac{1}{2}$ of stock for \$X, shareholder still owns 100%

Effect of Redemption

(slide 3 of 3)

- If not qualified as a redemption:
 - Shareholder reports dividend income
 - May be taxed at up to 38.6%
 - Redemption proceeds may not be offset by basis in stock surrendered
 - Corporate shareholders may prefer dividend treatment because of the dividends received deduction

Transactions Treated as Redemptions (slide 1 of 3)

- The following types of distributions may be treated as a redemption of stock rather than as a dividend:
 - Distributions not essentially equivalent to a dividend (subjective test)
 - Disproportionate distributions (mechanical rules)

Transactions Treated as Redemptions (slide 2 of 3)

- Distributions in termination of shareholder's interest (mechanical rules)
- Partial liquidations of a corporation where shareholder is not a corporation, and either
 - (1) Distribution is not essentially equivalent to a dividend, or
 - (2) An active business is terminated(May be subjective (1) or mechanical (2))

Transactions Treated as Redemptions (slide 3 of 3)

- Distributions to pay death taxes (limitation on amount of allowed distribution is mechanical test)
- Stock attribution rules must be applied, so distribution which appears to meet requirements may not qualify

Stock Attribution (slide 1 of 5)

- Qualified stock redemption must result in substantial reduction in shareholder's ownership
 - Stock ownership by certain related parties is attributed back to shareholder whose stock is redeemed

Stock Attribution (slide 2 of 5)

- Attribution from family members
 - Stock owned by spouse, children, grandchildren, or parents attributed back to individual

Stock Attribution (slide 3 of 5)

- Attribution from entity to owner:
 - Partner: deemed owner of proportionate number of shares owned by partnership
 - Beneficiary or heir: deemed owner of proportionate shares owned by entity
 - 50% or more shareholder: deemed owner of proportionate shares owned by corporation

Stock Attribution (slide 4 of 5)

- Attribution from owner to entity
 - Partnership: deemed owner of total shares owned by partner
 - Estate or trust: deemed owner of total shares owned by heir or beneficiary
 - Corporation: deemed owner of total shares owned by 50% or more shareholder

Stock Attribution (slide 5 of 5)

- Family attribution rules do not apply to redemptions in complete termination of shareholder's interest
- Stock attribution rules do not apply to redemptions to pay death taxes

Not Essentially Equivalent Redemptions (slide 1 of 3)

- Redemption qualifies for sale or exchange treatment if “not essentially equivalent to a dividend”
 - Subjective test
 - Provision was added to deal specifically with redemptions of preferred stock
 - Shareholders often have no control over when preferred shares redeemed
 - Also applies to common stock redemptions

Not Essentially Equivalent Redemptions (slide 2 of 3)

- To qualify, redemption must result in a meaningful reduction in shareholder's interest in redeeming corp
 - Stock attribution rules apply

Not Essentially Equivalent Redemptions (slide 3 of 3)

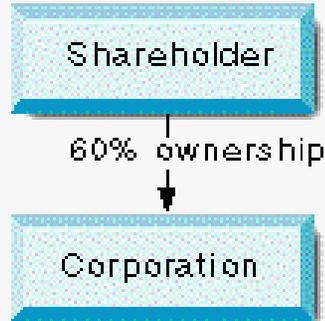
- If redemption is treated as ordinary dividend
 - Basis in stock redeemed attaches to remaining stock owned (directly or constructively)

Qualifying Disproportionate Redemption (slide 1 of 4)

- Redemption qualifies as disproportionate redemption if:
 - Shareholder owns less than 80% of the interest owned prior to redemption
 - Shareholder owns less than 50% of the total combined voting power in the corporation

Qualifying Disproportionate Redemption (slide 2 of 4)

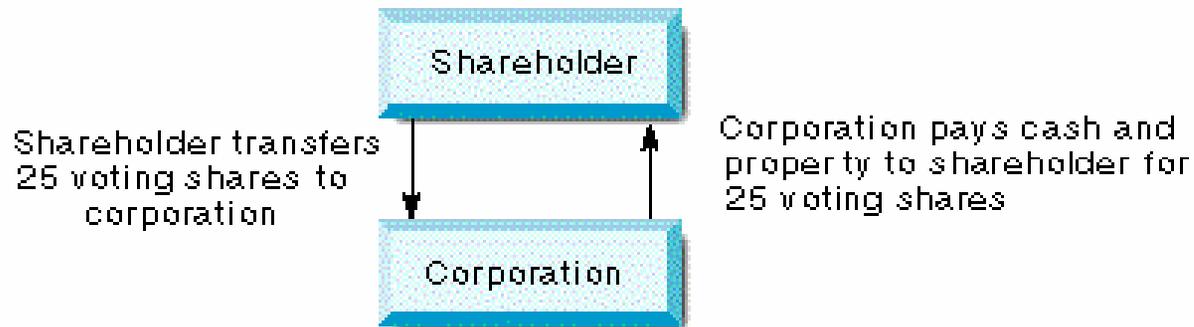
Setting



Has 60% ownership
represented by 60 of 100
outstanding voting shares

Qualifying Disproportionate Redemption (slide 3 of 4)

Redemption



Qualifying Disproportionate Redemption (slide 4 of 4)

- Shareholder has 46 2/3% ownership represented by 35 voting shares (60-25) of 75 (100-25) outstanding voting shares
- Redemption is qualified disproportionate redemption because:
 - Shareholder owns $< 80\%$ of the 60% owned prior to redemption ($80\% \times 60\% = 48\%$), and
 - Shareholder owns $< 50\%$ of total combined voting power of corporation

Complete Termination Redemptions

- Termination of entire interest generally qualifies for sale or exchange treatment
 - Often will not qualify as disproportionate redemption due to stock attribution rules
 - Family attribution rules will not apply if:
 - Former shareholder has no interest (other than as creditor) for at least 10 years
 - Agree to notify IRS of any disallowed interest within 10 year period

Redemptions To Pay Death Taxes (slide 1 of 2)

- Allows sale or exchange treatment if value of stock exceeds 35% of value of adjusted gross estate
 - Stock of 2 or more corps may be treated as stock of single corp for 35% test if 20% or more of each corp was owned by decedent
 - Special treatment limited to sum of:
 - Death Taxes
 - Funeral and administration expenses

Redemptions To Pay Death Taxes (slide 2 of 2)

- Basis of stock is stepped up to fair market value on date of death (or alternate valuation date)
 - When redemption price equals stepped-up basis, no tax consequences to estate

Effect of Redemption on Corporation (slide 1 of 2)

- Gain or loss recognition
 - If property other than cash used for redemption
 - Corporation recognizes gain on distribution of appreciated property
 - Loss is not recognized
 - Corporation should sell property, recognize loss, and use proceeds from sale for redemption

Effect of Redemption on Corporation (slide 2 of 2)

- Effect on Earnings and Profits
 - E & P is reduced in a qualified stock redemption by ratable share of E & P attributable to stock redeemed

Stock Redemptions-No Sale Or Exchange Treatment

- Redemptions not qualifying under previous provisions
 - Treated as dividend distribution to extent of E & P
 - Attempts by taxpayers to circumvent redemption provisions led to rules covering:
 - Preferred stock bailouts
 - Sales of stock to related corporations

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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