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:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Add</th>
<th>Subtract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax-exempt income</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Life insurance proceeds</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Deferred installment gain</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Excess charitable contribution</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Ded. of prior excess contribution</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Federal income taxes</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Officer’s life insurance premium</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Accelerated depreciation</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>
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
A $20,000 cash distribution is made in each independent situation:

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acc. E &amp; P, beginning of year</td>
<td>100,000</td>
<td>(100,000)</td>
<td>15,000</td>
</tr>
<tr>
<td>Current E &amp; P</td>
<td>50,000</td>
<td>50,000</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Dividend:</td>
<td>20,000</td>
<td>20,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

*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:

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Fair market value of distributed property</td>
<td>60,000</td>
<td>10,000</td>
<td>40,000</td>
</tr>
<tr>
<td>2. Liability on property</td>
<td>-0-</td>
<td>-0-</td>
<td>15,000</td>
</tr>
<tr>
<td>3. Gain(loss) recognized</td>
<td>40,000</td>
<td>-0-</td>
<td>20,000</td>
</tr>
<tr>
<td>4. E&amp;P increased by gain</td>
<td>40,000</td>
<td>-0-</td>
<td>20,000</td>
</tr>
<tr>
<td>5. E &amp; P decrease on dist.</td>
<td>60,000</td>
<td>20,000</td>
<td>25,000</td>
</tr>
</tbody>
</table>
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 ½ 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
• 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
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

Shareholder

60% ownership

Corporation

Has 60% ownership represented by 60 of 100 outstanding voting shares
Qualifying Disproportionate Redemption (slide 3 of 4)

Redemption

Shareholder transfers 25 voting shares to corporation

Corporation pays cash and property to shareholder for 25 voting shares
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% X 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

- 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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