Corporate Tax Segment 5A
Dividends

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Nonliquidating Distributions

Dividends - i.e., “operating” distributions
§301(a) - Subchapter C, Part A.
Alternative dividend classification systems:
1) Federal income tax - income tax; e&p
2) Financial accounting – GAAP/SEC
3) Regulatory - utility rate-making
4) State income taxation/franchise taxation
5) State corporate law/creditors’ protection
**Dividend Payment Alternatives**

A. **Ordinary** course of business
   1. cash
   2. property - appreciated/depreciated capital gain/ordinary income property installment obligations
   3. distributing corporation's own notes
   4. distributing corporation's own stock

B. **Extraordinary** course of business

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**Tax Definition of a “Dividend”**

§301(c) Ordering Rules
   1) §301(c)(1) - dividend distributions.
   2) §301(c)(2) - recovery of basis.
   3) §301(c)(3) - realization of capital gain.

§316 - Dividend distribution sourcing:
   1) accumulated “earnings & profits,” or
   2) current “earnings and profits” (i.e., the "nimble dividend" rule).
Dividend Taxation to the Individual Shareholder

§1(h)(11) - taxation at capital gains rates to the individual dividend recipient.

Must be “qualified dividend income”, i.e., received from (1) domestic corporation, or (2) foreign corporation satisfying specified criteria.

Must satisfy a holding period requirement.

Not dividends from a “money market fund.”

Defining “Earnings and Profits” for Tax Purposes

Code §312 concerns E&P concepts.

Objective: Identify a cash equivalent amount available for distribution to owners/shareholders; premised upon true economic results, not on taxable income base.

Choices for identifying “dividend” status:

1) Taxable 2) E&P 3) Earned surplus; income GAAP concepts
Adjustments to Taxable Income for E&P Amount

I. E&P Additions for Income Items
   - municipal bond income
   - life insurance proceeds (above basis?)
   - federal tax refunds

II. Deduction Addback Items to E&P
    - dividends to the corporate shareholder previously protected by a dividends received deduction for FIT purposes.

E&P adjustments, continued

III. Amounts deducted to determine E&P
    - Federal income taxes paid.
    - Disallowed losses - §265 and §267.
    - Charitable contributions above %limit.

IV Timing Adjustments for E&P
   A. Income components, e.g., §453.
   B. Depreciation components, e.g., §168.
E&P Computation Example

1. Determining Taxable Income

Gross income
- Sales profits: 20,000
- Dividends: 5,000
- Long-term capital gain: 2,500
  Total gross income: 27,500

Example, cont. 

Net Income Determination

Deductions
- Employee salaries: 10,250
- DRD - 70% of $5,000 (§243): 3,500
- Depreciation: 2,800
- LTCL (limited to gain): 2,500
  Total deductions: 19,050
  Total taxable income: 8,450
  (27,500 less 19,050)
E&P Determination

Taxable income  8,450

Increases to E&P:
  Tax-exempt interest  3,000
  Dividends received deduction  3,500
  Depreciation (2,800 less 1,000)  1,800
     (2,000 SL depreciation x ½ year)
Total increases to E&P  8,300

E&P Determination

Decreases to E&P Amount
  Excess LTCL  2,500
  Estimated federal taxes paid  800
Total decreases (3,300)

Earnings and profits total  13,450
(8,450 + 8,300 less 3,300)
Cash Distributions

1) Cash distribution to the shareholder is a “dividend,” but the dividend amount is limited to the distributing corporation's earnings and profits amount. Code §301.

2) Result to the corporation: Reduction of E&P by the amount of the distribution, limited to the amount of E&P (i.e., cannot create a negative amount in E&P account).

3) What allocation procedures (next slide)?

Allocation Procedures
Rev. Rul. 74-164

1) Current e&p is allocated proportionately to all current year distributions.

2) Accumulated e&p is allocated chronologically to distributions during the year (starting with the first distribution).

3) Current loss is allocated pro rata against accumulated e&p available on the date of the distribution, unless the date of the loss is specifically earmarked.
Example:

$10,000 tax basis to A for P stock.

P has $5,000 of current e&p and no accumulated e&p and distributes $17,500.

Result: a) $5,000 dividend - §301(c)(1)
   b) $10,000 return of capital - §301(c)(2); zero basis for the stock.
   c) $2,500 capital gain - §301(c)(3).

P's e&p is reduced to zero - §312(a)(1).

Example (b)

$15,000 accumulated deficit in e&p from prior year and $10,000 of current e&p & corp. distributes $10,000 currently.

Result: the entire $10,000 distribution is a dividend to A under the "nimble dividend" rule (current e&p).

P continues to have a $15,000 deficit in its e&p (i.e., no adjustments to e&p).
No current e&p (after the distribution).
**Example (c)**

Facts:  (i) $10,000 of accumulated e&p before year two (to be allocated chronologically) and (ii) $4,000 of current e&p (pro-rated).

1) **April 1** distribution of $10,000.
   2,000 (pro rata portion of 4,000) of current E&P; also, 8,000 of 10,000 accumulated E&P received as a dividend distribution.

*continued*

**Example (c) continued**

2) **October 1** distributions of $5,000 & $5,000 to two shareholders.
   $2,000 current E&P (1,000 each shareholder).
   $2,000 remaining accumulated E&P (10,000 less 8,000) allocated 1/2 (1,000) to each shareholder.  $3,000 return of capital.

3) On **July 1** shareholder sells 1/2 of stock for 15k  (impact on/of the October transaction?)
   Zero E&P of corp. after these distributions.
Example (d)

P has a $10,000 deficit in Year Two.
1) **April 1** distribution of $10,000
   1/4th of 10,000 loss (2,500) allocable to the April 1 distribution of 10,000 (no earmarking); 7,500 dividend (reducing e&p to zero) & 2,500 return of capital.
   Stock basis is reduced from 10,000 to 7,500.

Example (d), cont., Option One (chronological)

2) **July 1** - A sells 1/2 of stock for 15k.
   (15,000 less 3,750 (1/2 basis) = 11,250 gain)
3) **October 1** distribution of $5,000 & $5,000 to two shareholders - No current e&p & no accumulated e&p. Treatment to A:
   Less: distribution 5,000
   Basis is: 3,750
   Result: 1,250 gain
Example (d), cont., Option Two (dividends 1st)

2) October 1 distribution of $5,000 & $5,000. No current e&p & no acc. e&p. Options:
   Basis is: 7,500 3,750 (1/2?)
   Less: distrib. 5,000 5,000
   Result: 2,500 1,250 (basis) (gain)

3) July 1 sale of 1/2 stock for 15k: 11,250 gain or 13,750 gain (15x less 1/2 of 2,500 or 1,250).

Distributions of Property to Shareholders

Income tax issues upon property distribution:
1) Income recognition to the distributing corporation upon a distribution in kind?
2) Effect on E&P from the distribution event and the gain recognition to the corporation.
3) Dividend treatment to the shareholder receiving the property as a distribution (fmv).
4) Tax basis to the shareholder for the property received in the distribution.
Example (a)

Z purchased S stock for $8,000.
S has $25,000 accumulated e&p and no current e&p. Distribution of inventory made:
$20,000 FMV and $11,000 basis.
1) S has recognized gain of $9,000.
2) $9,000 gain produces S current e&p.
3) The entire $20,000 is dividend to Z.
9,000 current e&p and 11,000 of acc. e&p.

Example (a), continued

4) Basis to Z for the inventory received:
   $20,000 (FMV) - §301(d).
5) Remaining E&P is $14,000:
   25,000 prior E&P, plus 9,000 current E&P, less 20,000 distribution, equals 14,000.
   §312(b)(2). Not considering the impact of federal income tax imposed on the 9,000 gain realized.
Example (b)

S has no accumulated e&p and no current e&p. Distribution of inventory:

$20,000 FMV and $11,000 basis.

1) Distribution produces to the corporation $9,000 gain (ord. income) & $9,000 current e&p (less any income tax on the $9,000 gain).

2) Result to shareholder - Distribution of the $20,000 inventory: 9,000 dividend, 8,000 basis recovery & 3,000 cap. gain. §301(c)(2).

Example (c)

Distribution of land: $20,000 FMV; 11,000 basis; 16,000 mortgage debt.

1) $9,000 income is realized by corporation on the distribution. §311(b)(1).

2) E&P increased by 9,000 - §312(b)(1).

3) Distribution to shareholder is $4,000 - 20,000 less 16,000 debt. §301(b)(2).

Dividend income is 4,000 - adequate e&p.
Example (d)

$25,000 acc. e&p and 15,000 current e&p. Corp. distributes depreciated land with a 20,000 fmv and a 30,000 tax basis.
1) §311(a) - no recognition of loss occurs.
2) 20,000 dividend distribution made to the shareholder.
3) 20,000 tax basis to shareholder - §301(d).
4) E&P is reduced by $30,000 - §312(a)(3).

Example (e)

Assume $25,000 acc. e&p and distribution of used machinery - 10,000 fmv; zero income tax basis; 2,000 E&P tax basis (five year property and 7 year class life).
Purchased for $14,000 on July 1 of year one.
Distribution made on January 1 of year 7.
Separate depreciation schedules for:
(i) income tax, and (ii) E&P calculation.
Reg. §1.312-15(d).
Example (e) cont.,
Distribution effects

1) 10,000 ordinary income for taxable income purposes - §311(b)(1) & §1245.

2) 8,000 income for e&p purposes upon the distribution of the asset. E&P tax basis is 2,000 (14,000 cost less 12,000).

3) Distribution of 10,000 to the shareholder.

4) E&P is reduced by 10,000 - §311(a) & (b).

5) Remaining E&P? 25 + 8 less 10 = 23k.

Corporate Distributions of its Own Obligations

Treatment of the corporation:
1) §311(b)(1)(A) - gain recognition is required by a corporation on the distribution of appreciated property "other than an obligation of such corporation".

2) The corporation's e&p is reduced by the principal amount of the obligation (or, alternatively, the “issue price”, if a lesser value). Code §312(a)(2).
Corporation’s Own Obligations Received, cont.

Shareholder distributee level:

1) dividend to the shareholder for the fair market value of the obligation received (i.e., not the "face value" of the instrument).

2) tax basis to the shareholder for the obligation received as a dividend is the fair market value of that obligation when received.

Example Distribution of OID Obligation

Shareholder stock basis is $100,000.
Corporation's e&p is $100,000.
On Jan. 1 Corporation distributes its own $100,000 30 yr. note bearing no interest - $5,000 FMV for the promissory note. No corp. gain on this distribution.
On Feb. 1 Corp. also distributes $100,000 of cash.
Results: 1) Under §312(a)(2) the Jan. 1 distribution of the note reduces e&p by its $5,000 issue price.
2) The Feb. 1 distribution is a $95,000 dividend.
Constructive Dividends Reg. §1.301-1(j).

Types of disguised dividend distributions:
1) Excessive compensation to shareholders.
2) Personal expense reimbursements.
3) Excessive rent for use of property.
4) Excessive interest on debt, or interest paid on debt which really constitutes equity.
5) Bargain sales of property to shareholders.
6) Interest-free loans to shareholders.

Nicholls, North, Buse Co. v. Commissioner

Corporate ownership of yacht and personal use of yacht by a son of the majority owner.
1) Constructive dividend for personal use.
2) Use was imputed to the father (not son).
3) Amount of the dividend:
   a) Not the purchase price of the yacht.
   b) But, value of the personal use of the yacht for one year.
**Rev. Rul. 69-630, Triangular Dividend**

Two corporations wholly owned by the same individual shareholder & §482 reallocation:
1) Increased income of X (since X should have received more income for the property).
2) Increased basis of property to Y (should have paid more for the purchased asset).
3) Distribution from X to Controlling Shareholder A (upstream dividend).
4) Contribution by A to the capital of Y.

**Constructive Dividends & 2003 Legislative Impact**

Taxation of dividends to the shareholder at the rate of 15% in 2003 (through 2010).
Cf., maximum income tax rate of 35% for compensation income received.
Better to have excess compensation treated as a constructive dividend rather than as compensation?
Consider also the social security tax and related considerations for compensation.
The Dividends Received Deduction - §243

Availability of the §243 “dividends received deduction” to the recipient corporation:
1) 70% - corporate investment situations;
2) 80% if 20% to 80% corporate ownership;
3) 100% if the dividend is paid to an affiliated group member.

Anti-Avoidance Limitations on the DRD

A. Limits on the §243 “dividends received deduction”: 45 of 91 day holding period requirement - §243(c).

Note re 2003 tax legislation: separate holding period rule limit (60 days in 120 day period) to enable the 15% dividend tax rate. §1(h)(11)(B)(iii)(I).
Anti-Avoidance Limitations cont.

B. Treatment of extraordinary dividends, i.e., “dividend stripping”:
   1) tax basis reduction and then gain recognition after the basis recovery. §1059.
   2) “extraordinary dividend” occurs when 10% plus of tax basis (or FMV) received in an 85 day (or shorter) period.


Anti-Avoidance Limitations cont.

C. Debt financed portfolio stock limitation on the deduction - §246A.

Debt must be attributable to “portfolio stock”, i.e., less than a 50 percent interest.

Proportionate disallowance if portfolio debt only partially financed.

Reduction in DRD limited to amount of interest expense deduction allocable to the dividend.
Anti-Avoidance Limitations cont.

D. §301(e) - e&p adjustments.

Objective: To limit the DRD for corporations, e.g.:
1) when E&P is increased because of slower depreciation schedules for E&P purposes, or
2) installment sale recognition for E&P but not for taxable income purposes.

Example: DRD Eligibility - 45 day rule

Investor corporation purchases 1,000 shares of publicly held common stock for $15,000 on June 3, collects $1,000 dividend on June 10, and sells stock for $14,000 on June 15.

Anticipation: 1,000 dividend & 70% DRD = 300 ordinary dividends, plus 1,000 STCL.

Example (a): §246(c) results in denial of DRD.
1) $1,000 of ordinary income, and
2) $1,000 STCL on sale of stock.
Example, cont.

(b) Stock is retained until December 1 (rather than being sold on June 15):
§246(c) DRD limitation would not apply since the 45 day minimum holding period requirement (during the specified 90 day period) has been satisfied in this situation.

Example, cont.

(c) Publicly Held pays second $1 per share dividend on August 15.
§1059(c)(3) becomes applicable and a $2,000 dividend is treated as received.
The total dividends exceed 10 percent of tax basis for the stock (since tax basis is $15,000 and the total dividends are $2,000).
Basis is reduced by the nontaxed portion of the extraordinary dividend (i.e., by $1,400).
Example, cont. Extraordinary Dividend?

(d) Dividends received total $2 per share but stock is held for 25 months before sold. Under §1059(a) stock must be held for more than two years before the dividend announcement date to avoid §1059. The $2,000 dividend would be an extraordinary dividend under §1059(c). Basis is to be reduced by the nontaxed portion (2,000 less 600 (taxed) = $1,400).

Example, cont.

(e) Investor purchases stock for $15,000 by borrowing $15,000 secured by the stock and paid $1,500 interest expense during the year and received $1,000 dividends. Under §246A(d)(3) the $15,000 is “portfolio indebtedness” with respect to the stock. Under §246A(a) the §243 deduction is 70 percent of zero (100% less 100%). The $1,000 dividend is fully taxable.
Example, cont.

(f) Investor borrows only $7,500 of the $15,000 total cost to acquire the stock.

The "average indebtedness percentage" would be only 50 percent. §246A(d).

Under §246A(a) the dividends received deduction is 70% times 50%, or 35%.

Of the $1,000 dividend received the DRD would be available for 35 percent of the total $1,000 dividend (or $350).

Dividends Paid in Bootstrap Sales

TSN Liquidating Corp. v. U.S.,

Assets distributed by subsidiary to parent immediately prior to the sale of stock of sub.

Issue: (i) dividend (& DRD), or

(ii) sale of stock (if stock sale - §453 installment sales treatment not available because of then applicable 30 percent limit on initial payment in installment sales).

Held: DRD available (dividend before sale).
Example

Strap Corp as sole shareholder of X, Inc.
X stock held more than two years.
Therefore, no §1059 applicability.
Strap basis of $150,000 in X stock.
Boot willing to purchase X stock from Strap
for $500,000. X has $100,000 cash.
X will distribute $100,000 to Strap.
Strap will sell X stock to Boot for $400,000.

Example, cont.

Strap would receive a 100% DRD - if the
form of the transaction is respected.
Strap’s LTCG would then be $250,000 (400
less 150 tax basis).
Here the unwanted asset is fungible cash -
and is the distribution part of the sale?
Stronger step transaction argument for IRS?
Dividend excluded if a consolidated return.
Problem, cont.

If Strap is an individual: IRS would argue for dividend treatment since the $100,000 dividend would be treated as ordinary income (subject to tax at ordinary income tax rate, rather than the 15% rate for capital gains); but impact after 2003 Act?

Planning in this context: have the individual Strap redeem $100,000 worth of stock immediately before the sale to Boot?