Chapter 4  Nonliquidating Distributions

Dividends - i.e., “operating” distributions
See IRC §301(a) - Subchapter C, Part A.

Alternative dividend classification systems:
1) Federal income tax– income tax; & e&p
2) Financial accounting – GAAP/SEC rules
3) Regulatory - utility rate-making
4) State income taxation/franchise taxation
5) State corporate law/creditors’ protection rules
Dividend Payments - Alternatives for Corp.

A. Ordinary course of business

1. cash

2. property – a) appreciated/depreciated
   b) capital gain/ordinary income property
   c) installment obligations

3. distribution of corporation's own notes

4. distribution of corporation's own stock

B. Extraordinary course of business
Tax Definition of a “Dividend”

§301(c) Income Tax Ordering Rules

1) §301(c)(1) - dividend distributions.
2) §301(c)(2) - recovery of tax 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).
§1(h)(11) - taxation at capital gains rates (20%) to individual dividend recipient. “Permanent” rate. Must be “qualified dividend income”, i.e., received from: (1) domestic corporation, or (2) foreign corporation (if satisfying specified criteria). §1(h)(11)(C)(i)(II) & Notice 2011-64. Must satisfy a holding period requirement.

“Dividends” from a “money market fund”? Not eligible for 20% rate. Why?

Does the 20% rate incentivize the economy?
Why pay (or not pay) dividends?
- Retain earnings for future investments?
- Reduce borrowing costs through the retention of corporate earnings?
- Pay out earnings for closely held corp. shareholders but only in a deductible form?
- Any effect on institutional shareholders?

Cf., better use of capital after distributions have been made to the shareholders?
Defining “Earnings and Profits” for Tax Purposes

P. 155. 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 the “taxable income” base.

Choices for identifying “dividend” status:

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

I. E&P Additions for Income Items (p.156)
   - municipal bond income - §103
   - life insurance proceeds (above tax basis?)
   - federal tax refunds – tax not deductible

II. Deduction Addback Items to E&P (p.156)
    - dividends to the corporate shareholder from another corp. & previously protected by a dividends received deduction (DRD) for FIT purposes.
E&P adjustments, continued

III. Nondeductible amounts which do reduce the E&P amount (p.157)

- Federal income taxes paid by the corp.
- Disallowed losses - §265 and §267.
- Charitable contributions above % limit.
- Disallowed T& E expense - §274.

These are “cash out of pocket” items but are not deductible for FIT purposes.
E&P adjustments, continued  §312(k)&(n)


A. Income components, e.g., §453 or the (if available?) “completed contract” method. P.158.

B. Depreciation components, e.g., §312(k)(3)(A) & §168(g)(2). Use alternative depreciation system. Also, §179 deduction (amortize over 5 yrs. for E&P).

C. Inventory – FIFO method; not LIFO.

NOTE: (i) No statute of limitations on an E&P determination. (ii) No PLR re E&P status.
Problem  
Income & E&P Determinations  

I. Determining *Taxable Income*

Gross income

- Sales (gross) profits: 20,000
- Dividends from corp.: 5,000
- Long-term capital gain: 2,500

Total gross income: 27,500
### Net Income Determination continued, p.169

#### Deductions

<table>
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<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Employee salaries</td>
<td>10,250</td>
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<tr>
<td>DRD - 70% of $5,000 (§243)</td>
<td>3,500</td>
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<tr>
<td>Depreciation</td>
<td>2,800</td>
</tr>
<tr>
<td>LTCL (limited to gain)</td>
<td>2,500</td>
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<tr>
<td><strong>Total deductions</strong></td>
<td><strong>19,050</strong></td>
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<tr>
<td><strong>Total taxable income</strong></td>
<td><strong>8,450</strong></td>
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(27,500 less 19,050)
E&P Determination Adjustments

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 adjustments, cont.**

<table>
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<th>Description</th>
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<tr>
<td>Excess LTCL</td>
<td>2,500</td>
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<tr>
<td>Estimated federal taxes paid</td>
<td>800</td>
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<tr>
<td><strong>Total decreases</strong></td>
<td><strong>(3,300)</strong></td>
</tr>
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</table>

**Earnings and profits total**  
(8,450 + 8,300 less 3,300)
1) Cash distribution to the **shareholder** is a “dividend,” but the **dividend** amount (ord. income for FedTax) is limited to the distributing corporation's “E&P” amount. Code §301.

2) Result to the **corporation**: Reduction of E&P by the distribution amount, 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 during the year).

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

Distribution Exceeding E&P

$10,000 tax basis to Ann for Pelican stock. Pelican 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); then, zero basis for the stock.

c) $2,500 capital gain - §301(c)(3).

Pelican's e&p is reduced to zero - §312(a)(1).
Problem (b)                      p.163
“Nimble Dividend” Rule Effect

$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 Ann under the "nimble dividend" rule (sourced from current e&p).

Pelican continues to have a $15,000 deficit in its e&p (i.e., no adjustments to e&p account).

No current e&p exists after the distribution).
Problem (c)  Distributions & Mid-Year Stock Partial Sale

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 allocation).

1) April 1 distribution of $10,000. 2,000 (pro rata portion of 4,000 current E&P); & then 8,000 of the 10,000 accumulated E&P (1st come/1st served) is received as a dividend distribution.

continued
Problem (c) continued p. 163

2) October 1 distributions of $5,000 & $5,000 to (now) two shareholders.

$2,000 current E&P (1,000 each shareholder).

$2,000 remaining accumulated E&P (10,000 less 8,000 on April 1) allocated 1/2 (1,000) to each shareholder. Each has a $3,000 capital return (5,000 less 1,000 and less 1,000).

Zero E&P of corp. after these distributions.
Problem (c) continued
p. 163

3) On July 1 shareholder sells 1/2 of stock for 15k. What basis, including impact on/of the October transaction?

a) Original basis of $10,000 & sold ½ equals $5,000 tax basis to this sale.

b) Plus, 1,500 (½ of $3,000 basis return on 10-1)

Equals: 15,000 less 6,500 (5,000 plus 1,500) or 8,500.
Problem (d)                     p.163
Current Year Deficit

Pelican has a $10,000 deficit in Year Two.
1) April 1 distribution of $10,000 to Ann
   1/4th of current 10,000 loss (2,500) is allocable to
   the April 1 distribution of 10,000 (no earmarking);
   7,500 dividend (reducing e&p from prior year to
   zero) & 2,500 return of capital to Ann.
   Ann’s stock basis is reduced from 10,000 to 7,500.

continued
Problem (d)                      p.163
Current Year Deficit

2) October distribution of $5,000 to Baker
   (No e&p & therefore, no dividend)
   Purchase basis on July 1  15,000
   Basis reduced – 10-1 distribution  5,000
   Baker’s remaining basis  10,000

continued
Problem (d), cont., p.163
Option One (dividends 1st)

2) October 1 distribution of $5,000 to Ann.
No current e&p & no acc. e&p. Ann’s results:

Option(s): Basis is: 7,500 3,750 (1/2?)
Less: distribution 5,000 5,000
Result: 2,500 1,250
(basis) (gain)

3) July 1 sale of 1/2 stock for 15k: (a) 11,250 gain (less 3,750 basis) or (b) 13,750 gain (15x less 1/2 of 2,500 or 1,250).
2) **July 1** - Ann sells 1/2 of stock for 15k.
   
   \[(15,000 \text{ less } 3,750 \text{ (1/2 basis) } = 11,250 \text{ gain})\]

3) **October 1** distribution of $5,000 to Ann.

   No current e&p & no accumulated e&p.

   Treatment to Ann:

   Less: distribution \hspace{1cm} 5,000

   Basis is: \hspace{1cm} 3,750

   Result: \hspace{1cm} 1,250 \text{ gain}
Prior history: General Utilities doctrine, i.e., no gain recognized when appreciated property is distributed in non-liquidating distribution.

Not treated as a sale, but certain limitations such as tax benefit rule and substance over form.

See Code §311(a)(2).

Repealed in TRA-86.
Income tax issues to the corporation upon a property distribution:

1) Income (loss?) recognition to the distributing corporation upon a distribution in kind? Gain for excess of FMV over tax basis to be recognized. §311(b). Cf., §311(a)(2) re no loss recognition.

2) What effect on E&P from (a) this gain recognition to the corporation and (b) the distribution event? See §312(b).
Corporate Distributions of its Own Obligations  p.167

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).
Income tax issues to the shareholder upon a property distribution:

1) **Dividend** treatment to the shareholder receiving the property as a distribution (for the fmv of property)? Yes, as reduced by any liabilities (assumed or attached to property).

2) Tax **basis** to the shareholder for the property received in the distribution? FMV of property (**not** reduced by any assumed/attached debt).
Corporation’s Own Obligations Received

Treatment to Shareholder distributee:

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 by the shareholder.
Zane purchased Sturdley stock for $8,000. Sturdley has $25,000 accumulated e&p and no current e&p. Distribution of inventory is made: $20,000 FMV and $11,000 basis.

1) Sturdley has recognized ordinary gain of $9,000.
2) $9,000 gain = current e&p for Sturdley.
3) The entire $20,000 is dividend to Zane. (9,000 current e&p and 11,000 of acc. e&p.) cont.
Problem (a), continued p. 168

4) Tax basis to Zane for the inventory received:
   $20,000 (FMV) - §301(d). Holding period?

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 the federal income tax
   liability on the $9,000 gain realized on the inventory
distribution.
Problem (b)  p.168
No Pre-Distribution E&P

Sturdley has no accumulated e&p and no current e&p. Distribution of the appreciated 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 the shareholder - Distribution of the $20,000 inventory: 9,000 dividend, 8,000 share tax basis recovery, & 3,000 cap. gain. §301(c).
Problem (c)                      p.168
Mortgaged Property

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

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

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

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

Dividend income is 4,000 - adequate e&p exists. FMV basis to the shareholder for the land.
$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 is made to the shareholder. §301(b)(1).

3) 20,000 tax basis to shareholder - §301(d).

4) E&P is reduced by $30,000 - §312(a)(3) & 10,000 E&P for the future (25 + 15 less 30 = 10).
Alternate: Property Sale

First, a sale of the depreciated property:
10,000 loss reduces corporation’s (1) taxable income and (2) current E&P (15 less 10 equals 5).
Distribution of 20,000 cash produces 20,000 dividend; acc. E&P is reduced to 10,000 (25,000 plus 5,000 current less 20,000).
But, shareholder might want the land for other (e.g., sentimental) reasons.
Problem (e)                      p.168
Different tax bases

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 seven year class life).

Purchased for $14,000 on July 1 of year one. Distribution was made on January 1 of year 7.

Separate depreciation schedules for:
(i) income tax, and (ii) E&P calculation.

Reg. §1.312-15(d).  continued
Problem (e) cont., p.168
Distribution effects

1) 10,000 ordinary income to Corp. 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 depreciation).
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.
Constructive Dividends
Reg. §1.301-1(j). p.168

Types of disguised dividend distributions:
1) Excessive compensation paid to shareholders.
2) Personal expense reimbursements.
3) Excessive rent for corp. use of owner’s property.
4) Excessive interest paid on corp. debt, or interest is paid on debt which really constitutes equity.
5) Bargain sales of corp. property to shareholders.
6) Interest-free loans made to shareholders. §7872.
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 (to father):
   a) Not the purchase price of the yacht.
   b) But, value of the personal use of the yacht for one year.
Constructive Dividends & 20% Dividends Tax Rate

Taxation of dividends to the shareholder at the rate of 20% (after ATRA-2012).

Cf., maximum income tax rate of 39.6% for compensation income received.

Better to have excess compensation treated as a constructive dividend rather than as compensation?

Consider also the social security tax (12.4% of $113,700, plus 2.9%) and related considerations for compensation (in lower compensation ranges).
Availability of the §243 “dividends received deduction” to the recipient corporation:

1) 70% - corporate investment situations;
   (10.5% effective tax rate, i.e., 30% x 35%)
2) 80% DRD if 20% to 80% corporate ownership of another corporation’s stock;
3) 100% DRD if the dividend is paid to an “affiliated group” member (i.e., above 80%).
A. Limits on the §243 “dividends received deduction”: 45 of 91 day holding period requirement - §246(c)(1)(A). Longer holding period (90 days of 181 day period) for preferred stock. Objective: must hold stock & have market risk to enable DRD.

Note re 2003 tax legislation: separate holding period rule limit (60 days in 120 day period) to enable the 20% (previously 15%) dividend tax rate provided in §1(h)(11)(B)(iii)(I).
B. Treatment of extraordinary dividends, i.e., “dividend stripping” transactions:

1) tax basis reduction (for nontaxed portion) and gain recognition after the basis recovery. §1059.

2) “extraordinary dividend” occurs when 10% plus of tax basis (or FMV) amount (5% for preferred stock) is received in an 85 day (or shorter) period.

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

Debt incurred must be attributable to “portfolio stock” (i.e., less than a 50% interest).

Proportionate disallowance occurs if the portfolio debt only partially finances the acquisition.

Reduction in DRD is limited to the amount of interest expense deduction allocable to the dividend. Direct attribution to debt.
D. §301(e) – downward e&p adjustments.

Objective: To limit the DRD (for 20% plus corporate shareholders), e.g.:

1) when E&P is increased because of slower depreciation schedules for E&P purposes (than the usual §167/168 formula), or

2) installment sale recognition for E&P but not for taxable income purposes.
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.

Problem (a): §246(c) results in denia of the DRD.

1) $1,000 of ordinary income, and
2) $1,000 STCL on sale of stock.
(b) Stock is retained until December 1 (rather than being sold on June 15):

The §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.
(c) Publicly Held pays a second $1 per share dividend ($1,000) on August 15.

§1059(c)(3) becomes applicable and a $2,000 total dividend is treated as received.

The total dividends exceed 10 percent of the 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).
(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).
(e) Investor purchases stock for $15,000 by borrowing $15,000 secured by the stock and paid $1,200 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% = 0).

The $1,000 dividend is fully taxable.
(f) Investor borrowed only $7,500 of the $15,000 total cost to acquire the stock. The “average indebtedness percentage" would then be only 50%. §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., p.181

Assets are distributed by subsidiary to parent corp. 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 was not then available because of the applicable 30 percent limit on the initial payment in installment sales).

Held: DRD is available (dividend before the sale).
Strap Corp as the 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.
Problem, p. 193

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.

continued
Problem p.193, 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 20% rate for capital gains).

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