A double tax seemingly results because distributions provide no deduction to the paying corporation and often require income recognition by the shareholders. When dealing with corporations, the tax treatment of distributions often raises issues such as the following:

- The availability of earnings to be distributed.
- The basis of the shareholder’s stock.
- The character of the property being distributed.
- Whether the shareholder gives up ownership in return for the distribution.
- Whether the distribution is liquidating or nonliquidating.

CORPORATE DISTRIBUTIONS

Distributions by a corporation to its shareholders are presumed to be dividends unless the parties can demonstrate otherwise. Section 316 makes such distributions dividend income to the shareholder to the extent of E & P of the distributing corporation (accumulated since 1913) or to the extent of E & P for the current year.

The portion of a distribution not taxed as a dividend (because of insufficient E & P) is nontaxable to the extent of the shareholder’s basis in the stock and will reduce that basis accordingly. Any excess of the distribution over the shareholder’s basis usually is a capital gain.

EARNINGS AND PROFITS (E & P)

E & P (earnings and profits) is the factor that fixes the upper limit on the amount of dividend income a shareholder must recognize. It represents the corporation’s economic ability to pay a dividend without impairing its capital.

E & P, though similar to the financial accounting concept of “retained earnings,” differs from retained earnings in several respects.

a. A capitalization of a stock dividend does not decrease E & P; it does decrease retained earnings.

b. E & P is reduced only by straight-line depreciation unless the corporation uses a depreciation method such as “units of production” or “machine hours.”

c. E & P may be affected by gains and losses from property transactions only to the extent they are recognized for tax purposes (e.g., like-kind exchanges are not recognized for taxable income determination or for E & P purposes).

Computation of E & P

Accumulated E & P. Accumulated E & P is the balance in the E & P account at the beginning of the tax year.

Current E & P. Current E & P is the E & P attributable to the current year’s operations. It is the current year’s addition to E & P.

To compute E & P, taxable income is increased for all tax-exempt income items such as municipal bond interest, excluded life insurance proceeds (in excess of cash surrender value), dividends not taxed due to the dividends received deduction, and Federal income tax refunds for taxes paid in prior years. Then, taxable income is decreased by nondeductible expenses and losses to determine E & P. These nondeductible expenses include related-party losses, excess capital losses, Federal income taxes paid, fines and penalties, expenses incurred to produce tax-exempt income, and key employee life insurance premiums (in excess of increases in cash surrender value).
Some E & P adjustments shift the effect of a transaction from the year it impacts taxable income to the year when it has an economic effect on the corporation. Charitable contribution carryovers, NOL carryovers, and capital loss carryovers all fit in this class of adjustments.

A final class of adjustments to taxable income to determine E & P relate to differences in accounting methods required for E & P and taxable income. Included in this group are adjustments required for depreciation, § 179 expense, installment sales, intangible drilling costs, mining exploration and development costs, amortization of circulation expenditures, trademarks, organizational expenditures, and accounting for construction contracts.

If accelerated depreciation is used to compute taxable income, the adjustment to E & P is determined using the straight-line method.

a. For depreciation computed under MACRS, a corporation must use a recovery period equal to the asset's asset depreciation range (ADR) midpoint life.
b. No additional first year depreciation is allowed for E & P purposes.
c. The ADR midpoint life for most assets is set out in Rev. Proc. 87-56, 1987-2 C.B. 674. The recovery period is five years for automobiles and light-duty trucks and 40 years for real property. For assets with no class life, the recovery period is 12 years.
d. When the asset is later sold, the increase or decrease to E & P is computed by using the adjusted basis of the asset for E & P purposes.

Section 179 expenses must be deducted over five years. Thus, in the year § 179 is elected, 80% is added back to taxable income to arrive at E & P. In each of the following four years, 20% of the expense is subtracted from taxable income to determine E & P.

E & P is increased by the amount of any deferred gain in the year in which a corporation sells property on the installment basis. This is accomplished by treating all principal payments as having been received in the year of sale for purposes of computing E & P.

Intangible drilling costs allowable as a deduction under § 263(c) and mineral exploration and development costs allowable as a deduction under §§ 616(a) or 617 are required to be capitalized for purposes of computing E & P. Once capitalized, these expenditures are charged to E & P over a specified period (i.e., 60 months in the case of intangible drilling costs and 120 months for mine exploration and development costs). Any unamortized balance is written off when the well becomes dry or the mineral property is abandoned.

Amounts amortized under §§ 173 (relating to circulation expenditures), 177 (relating to trademark and trade name expenditures), and 248 (relating to organizational expenditures) are to be capitalized for purposes of determining E & P. There will be no amortization if the property does not have a reasonably determinable useful life.

Construction period interest, taxes, and carrying charges are required to be capitalized as a part of the asset to which they relate for purposes of computing E & P.

**Allocating E & P to Distributions**

Distributions are deemed to first come from current E & P. If there are multiple distributions during the year, then current E & P is allocated to distributions pro rata, using the amount of each distribution during the year as the basis for allocation.
Accumulated E & P is allocated to distributions in chronological order during the year, starting with the first distribution. (Example 8)

If a deficit exists in accumulated E & P and a positive balance exists in current E & P, the two accounts are not netted. Instead, distributions are taxed as dividends to the extent of the positive balance in current E & P.

If a deficit exists in current E & P and a positive balance exists in accumulated E & P, the two accounts are netted as of the date of the distribution. The distribution is treated as a dividend to the extent of a positive net balance. Deficit in current E & P is allocated ratably throughout the year, unless the parties can show otherwise.

If current E & P is unknown at the end of the shareholder's tax year (e.g., when the corporation uses a fiscal year and the shareholder uses a calendar year), current E & P is assumed sufficient to cover all distributions made during the year to the shareholder. If current E & P is determined to be insufficient to cover distributions at the end of the corporation's year, then the shareholder may file an amended return to claim a refund for taxes paid.

**NONCASH DIVIDENDS**
There is no requirement that dividends be in the form of cash. Property distributions to shareholders, like cash distributions, are considered dividends unless the parties establish that the distribution is something else.

*Noncash Dividends—Effect on the Shareholder*
Property distributed.

a. The amount distributed as a dividend in the form of property rather than cash is measured by the fair market value of the property on the date of distribution.
b. If the fair market value of the property distributed is greater than the balance in current and accumulated E & P, the excess is a return of capital to the extent of the shareholder’s basis in the stock.
c. If the fair market value of the property distributed is greater than the balance in the E & P accounts and basis the shareholders have in their stock, the excess is capital gain.

The amount distributed is reduced by any liabilities related to the property distributed assumed by the shareholder.

The basis of the property to the shareholder is the fair market value of the property on the date of the distribution.

*Noncash Dividends—Effect on the Corporation*
Under § 311(b), gain but not loss is recognized by a corporation that distributes property as a dividend.

a. The distribution of appreciated property is treated as if the property were sold to the shareholder at its fair market value.
b. Further, if the property distributed is subject to a liability, or if the shareholder assumes a liability that exceeds the basis of the distributed property, the fair market value of the property shall not be less than the amount of the liability.

The E & P of the distributing corporation is reduced by the amount of money distributed or:

a. By the greater of:
(1) The fair market value.
(2) The adjusted basis of the property distributed.
b. Less the amount of any liability on the property assumed by the shareholder.
c. Distributions cannot generate or add to a deficit in E & P.
d. Only corporate losses generate or add to a deficit in E & P.
The E & P of the distributing corporation is increased by the amount of appreciation of the distributed property.

CONSTRUCTIVE DIVIDENDS

Constructive dividends.

a. Usually arise in the context of a closely held corporation. They need not be formally declared or issued pro rata.
b. Any economic benefit conveyed by a corporation to a shareholder can, by default, be considered a constructive dividend unless the parties can demonstrate that the transfer qualifies for alternative tax treatment.

Types of Constructive Dividends

Examples of constructive dividends are:

a. Personal use by a shareholder of corporate-owned property (e.g., company-owned automobiles, airplanes, yachts, hunting lodges). The measure of the dividend usually is the fair rental value of the property for the period of its personal use.
b. A bargain sale of corporate property to the shareholders. The measure of the dividend is the difference between the amount paid for the property and its FMV.
c. The bargain rental of corporate property to its shareholders. The measure of the dividend is the amount of the property’s fair rental value that exceeds the rent actually paid.
d. The satisfaction by the corporation of a shareholder’s personal obligation to a third party.
e. Unreasonable compensation.

(1) Employee/shareholders often attempt to avoid the effects of double taxation by having the corporation pay a salary sufficiently large to reduce the corporation’s taxable income to zero.
(2) The IRS relies on the “reasonable” language in IRC § 162 to limit the deductibility of excessive compensation. In determining the reasonableness of salary payments, the following factors are considered:

(a) The employee’s qualifications.
(b) A comparison of salaries with dividend distributions.
(c) The prevailing rates of compensation for comparable positions in comparable business concerns.
(d) The nature and scope of the employee’s work.
(e) The size and complexity of the business.
(f) A comparison of salaries paid with both gross and net income.
(g) The taxpayer’s salary policy toward all employees.
(h) For small corporations with a limited number of officers, the amount of compensation paid to the employee in question in previous years.
(i) For large corporations, whether a “reasonable investor” would have agreed to the level of compensation paid.

(3) The amount of compensation in excess of a “reasonable amount” is disallowed as a deduction to the corporation and is considered a constructive dividend to the shareholder.
f. Loans to shareholders.
The shareholder is deemed to have made an interest payment to the corporation to the extent of the forgone interest.

The corporation is then deemed to have made a dividend distribution to the shareholder for the same amount.

Although the shareholder may be permitted to deduct the deemed interest payment, the corporation has interest income.

No corresponding deduction is allowed to the corporation since the imputed interest element is a constructive dividend.

Excessive rentals paid by a corporation for the use of shareholder property.

**Tax Treatment of Constructive Dividends**

Constructive dividends are treated as actual dividend distributions.

a. The shareholder recognizes dividend income equal to the fair market value of the property received.

b. The shareholder’s basis also equals fair market value.

c. The distributing corporation’s E & P is reduced by the amount of the dividend.

d. Corporations receiving constructive dividends are entitled to the dividends received deduction.

**STOCK DIVIDENDS**

Definition: A stock dividend occurs when a corporation issues a dividend in the form of its own stock rather than in the form of cash or other property.

Tax treatment: Stock dividends are not taxable if they are pro rata distributions of stock, or stock rights, on common stock.

Exceptions: Section 305 provides that various disproportionate distributions are taxable.

a. Section 305(b) identifies five situations where stock dividends are taxable. They are:

   (1) If one shareholder can elect payment either in cash or in stock, all stock dividends are taxable.

   (2) Disproportionate distributions of stock dividends are taxable.

   (3) Distributions of common stock to some common shareholders and preferred stock to other common shareholders cause stock dividends to be taxable. A stock dividend of convertible preferred on common is taxable if it is reasonable to expect that some shareholders will convert their preferred shares to common shares and that others will keep their preferred shares.

   (4) Distributions on preferred stock are taxable (except for changes in the conversion ratio of convertible preferred made to account for a stock dividend or stock split).

   (5) Distributions of convertible preferred stock that will result in disproportionate distributions are taxable.

b. Section 305(c) provides that transactions increasing the proportionate interest of a shareholder are taxable even if they are not actually stock dividends.

If stock dividends are not taxable, there is no reduction in E & P. If they are taxable, the distribution is treated as any other property dividend and the holding period starts on the day of receipt.

If a stock dividend is not taxable, § 307 comes into play and a basis allocation is in order.

a. If the dividend shares are identical to the formerly held shares, the original basis is spread over the total number of shares now held:
Basis in old shares ÷ (Number of old shares + Number of new shares)

b. If the dividend stock is not identical, basis is determined by allocating the basis of the original shares between the old and new stock according to the fair market value of each:

New basis in old shares = Former basis in old shares × \(\frac{\text{FMV of old shares}}{\text{FMV of old shares} + \text{FMV of new shares}}\)

FMV of old shares + FMV of new shares

Basis in new shares = Former basis in old shares × \(\frac{\text{FMV of new shares}}{\text{FMV of old shares} + \text{FMV of new shares}}\)

STOCK REDEMPTIONS

Return of capital treatment. An effective stock redemption for tax purposes enables the shareholder to be treated as if he or she sold the stock to the corporation. If the stock is a capital asset in the hands of the shareholder (as is usually the case), then the end-product is a capital gain (or loss).

a. The shareholder always can achieve the same result (i.e., bailing-out a capital investment without dividend consequences) by selling the stock to third parties. This approach, however, allows outsiders to become shareholders. However, often corporations effect stock redemptions for the following reasons:

(1) To acquire the holdings of a retiring or deceased shareholder.
(2) To carry out a property settlement related to a divorce.
(3) To increase the per-share price of the stock as it trades in a market.
(4) To implement a business succession plan (e.g., using a buy-sell agreement to transfer shares from one generation of shareholders to a younger one).

b. If a stock redemption does not satisfy the requirements set forth in the Code, the result is a dividend (to the extent of the corporation’s E & P).

c. In light of the favorable tax rate treatment recently accorded to qualified dividends, the only advantage a stock redemption now provides is a tax-free recovery of capital (i.e., the basis in the stock).

d. Nonetheless, generally, to meet the requirements for sale or exchange treatment:

(1) All of the shareholders stock must be redeemed, or
(2) After the redemption, the investor:

• Owns less than 50% of the outstanding stock, and
• Owns less than 80% of the interest owned prior to the redemption.

If the transaction is given dividend treatment, the basis of the redeemed shares is allocated to the shareholders’ remaining shares.

CORPORATE LIQUIDATIONS

A corporate liquidation exists when a corporation ceases to be a going concern. The corporation sells or disposes of its assets, pays its liabilities, and distributes any remaining assets to its shareholders. Legal dissolution is not required for tax purposes.
The Liquidation Process
Shareholders may decide to liquidate a corporation for one or more reasons, including the following:
   a. The corporate business has been unsuccessful.
   b. The shareholders want to acquire the corporation’s assets.
   c. Another person or entity wants to purchase the corporation’s assets. The purchaser may buy the shareholders’ stock and then liquidate the corporation to acquire the assets.

Liquidating and Nonliquidating Distributions Compared
Distributions to shareholders in complete liquidation are generally given sale or exchange treatment and shareholders, therefore, are entitled to recover their basis in their stock before recognizing any gain. Thus, shareholders may recognize gain or loss upon liquidation.

Property distributions.
   a. Generally, when property is distributed by a corporation, it recognizes gain, but not loss. This rule applies to property dividends and property distributed in a qualified stock redemption.
   b. For property distributed in complete liquidation, however, the corporation may recognize both gain and loss (with some restrictions).

RESTRICTIONS ON CORPORATE ACCUMULATIONS
One way to avoid tax on dividends is to allow the earnings of the corporation to accumulate without being distributed. There are two provisions of the Internal Revenue Code, however, that impose a penalty tax on corporate accumulations. Both provisions are aimed at forcing corporations to distribute unneeded surplus.

The accumulated earnings tax imposes a penalty of 20% on additions to E & P in excess of the reasonable needs of the business.
   a. The burden of proof is on the taxpayer to establish the reasonable needs of the business.
   b. Most corporations have a $250,000 minimum credit below which they do not need to establish reasonable needs. Thus, corporations can accumulate $250,000 of E & P before being threatened with the accumulated earnings tax.
   c. The following items have generally been considered reasonable business needs:
      (1) To increase or maintain a reasonable amount of working capital.
      (2) Retirement of business debt.
      (3) Investment or loans to suppliers or customers.
      (4) Realistic business contingencies, including lawsuits or self-insurance.

The personal holding company penalty tax was designed to prevent corporations from being used to hold investment assets. For high marginal tax rate taxpayers, allowing income to accumulate at the corporate tax rate was preferable to having it accumulate at the individual marginal tax rate. The tax would apply if:
   a. More than 50% of the value of the outstanding stock was owned by five or fewer individuals at any time during the last half of the year, and
   b. A substantial portion (60% or more) of the corporation’s income is comprised of passive types of income, including dividends, interest, rents, royalties, or certain personal service income.
   c. The tax rate is 20% on undistributed personal holding company income.