CHAPTER 4

NONLIQUIDATING DISTRIBUTIONS

A. INTRODUCTION

1. DIVIDENDS: IN GENERAL

Code: §§ 243(a), (b)(1); 301(a), (c); 316(a); 317(a).

Regulations: §§ 1.301–1(c); 1.316–1(a)(1)–(2).

It has been said that a corporation derives no greater pleasure than through making distributions to its shareholders. As one court observed, "like the 'life-rendering pelican,' [a corporation] feeds its shareholders upon dividends."[1] In the case of a close corporation, however, this colorful marine analogy does not always capture reality. Closely held companies, influenced by the federal tax law, typically resist paying dividends and expend considerable energy to avoid the sting of the double tax. Many public companies retain profits for internal expansion, to finance acquisitions, or to repurchase their own stock.[2] But if an enterprise is successful, the pressure may mount to distribute earnings to the shareholders, and distributions often occur in connection with major changes in a corporation's capital structure, such as liquidations, mergers and recapitalizations. At that point, it becomes necessary to classify the distribution as a taxable dividend, a nontaxable return of capital, or as gain from a sale of the shareholder's stock. Simple as the task may seem, drawing these lines has been a central issue in the taxation of corporations and shareholders. Not surprisingly, the statutory scheme is complex and sometimes even illogical.

Distributions come in many forms. A corporation may distribute its own stock or debt obligations; redeem (i.e., repurchase) stock from its shareholders by distributing cash or property; or distribute its net assets in liquidation of the entire business. The tax consequences of these and other more complex transactions are considered in later chapters.[3] This chapter lays a foundation by examining the corporate and shareholder level tax treatment of nonliquidating (or "operating") distributions of cash or property—distributions commonly referred to as "dividends." We are about to learn, however, that not all distributions classified as

1 Commissioner v. First State Bank of Stratford, 168 F.2d 1004, 1009 (5th Cir.1948), cert. denied, 335 U.S. 867, 69 S.Ct. 137 (1948).

2 For an expanded discussion of the influence of federal tax law on corporate dividend policy, see Section A3 of this chapter, infra.

3 See Chapters 5–7, infra.

dividends under state law or designated as such in the corporate minutes are dividends for federal tax purposes.

Determining the tax consequences of a nonliquidating distribution requires an excursion through several sections of the Code. Section 301 governs the amount and classification to corporate and noncorporate shareholders of distributions of "property" made by a C corporation with

301 respect to its stock.[4] Under Section 301(c)(1), distributions that are

301(c)(1) "dividends" within the meaning of Section 316 must be included in gross income.[5] In order to prevent multiple taxation, corporate shareholders may deduct 50 percent (or sometimes 65 or 100 percent) of the dividends they receive.[6] Most dividends received by noncorporate shareholders are taxed at preferential long-term capital gains rates.[7] Distributions that are not dividends are first treated as a recovery of the shareholder's basis in his stock, and any excess over basis is treated as gain from the sale or exchange of the stock.[8]

316(a). Section 316(a) defines a "dividend" as any distribution of property made by a corporation to its shareholders out of (1) earnings and profits accumulated after February 28, 1913 ("accumulated earnings and profits") or (2) earnings and profits of the current taxable year ("current earnings and profits"). "Earnings and profits," a term of art to be examined in more detail below, is a concept that attempts to distinguish distributions of corporate profits from returns of capital. Section 316(a) also includes two irrebuttable presumptions: every distribution is deemed to be made out of earnings and profits to the extent that they exist and is deemed to be made from the most recently accumulated earnings and profits.

In testing for dividend status, the regulations look first to current earnings and profits, determined as of the close of the taxable year in which the distribution is made.[9] A distribution out of current earnings and profits is thus a taxable dividend even if the corporation has a historical deficit. This seemingly harsh rule was enacted many years ago as a relief measure to permit corporations with deficits to pay dividends

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[4] Distributions to shareholders in their other capacities (e.g., employee, creditor, lessor) are thus not embraced by Section 301. "Property" is deemed to include money and other corporate assets but not stock in the distributing corporation or rights to acquire stock. I.R.C. § 317(a).

[5] See also I.R.C. § 61(a)(7).

[6] I.R.C. § 243(a), (b)(1), (c). See Chapter 1D1 supra. Potential abuses of the dividends received deduction are policed by an assortment of Code provisions. See Section F of this chapter, infra.

[7] I.R.C. § 1(h)(11). See Section A2 of this chapter, infra.

[8] I.R.C. § 301(c)(2), (3). The rules in the text apply to distributions by C corporations that do not file a consolidated return. Distributions received by one member of a consolidated group from another member generally are tax-free, but the distributee must reduce its basis in the stock of the payor by the amount of the distribution. See Reg. § 1.1502–13(f)(2)(ii) and Chapter 13B, supra. Distributions by S corporations generally are tax-free to the extent of the shareholder's basis, and any excess is treated as gain from a sale of the S corporation stock. § 1368(b). See Chapter 15E, infra.

[9] Reg. § 1.316–1(a)(1).

and thus avoid an undistributed profits tax then in effect. Although the tax was later repealed, the "nimble dividend" rule survived without any Congressional explanation of why it was still necessary.[10] The rule at least simplifies the inquiry because it is rare for a company to make distributions during a period when it is operating at a loss. Only when distributions exceed current earnings and profits must reference be made to the historical track record of the corporation.

The dual focus in Section 316 on current and accumulated earnings and profits may produce anomalous results because dividend status is determined by reference to the corporation's overall financial success rather than the gain or loss realized by a particular shareholder. To be sure, most dividends represent an increase in the shareholder's wealth rather than a return of capital, but this is not inevitable under the current scheme. For example, the existence of accumulated earnings and profits will cause a distribution to be classified as a dividend even if those profits were earned before the shareholder acquired his stock.

To illustrate, assume that Shareholder forms Corporation with initial paid-in capital of $110. During its first year of operation, Corporation earns $20 and distributes $30 to Shareholder. The distribution consists of a $20 dividend (out of current earnings and profits) and a $10 return of capital, and Shareholder reduces his stock basis by $10 to $100. In year two, assume Corporation earns $50 and makes no distributions, ending the year with $50 of accumulated earnings and profits. At the beginning of year three, Buyer (an individual) acquires all the stock of Corporation for $150, and Shareholder realizes a $50 long-term capital gain. Assume further that Corporation, now wholly owned by Buyer, suffers a $10 loss in year three, causing its accumulated earnings and profits account to decrease to $40. If Corporation breaks even in year four but distributes $30, Buyer is taxed on the entire distribution because it is made from accumulated earnings and profits. But in substance Buyer has received merely a return of capital. After all, he paid $150 for the stock, and the company has since lost $10 while distributing $30 to Buyer, who is understandably surprised to realize $30 of ordinary income even though the value of his investment has declined.

In an academically tidy world, the curious result illustrated above should not occur. Instead, the tax treatment of distributions should depend on the gain or loss realized by the shareholder rather than the corporation's financial track record over time. Ideally, Shareholder should be taxed at ordinary income rates to the extent that the gain on a sale of his stock is attributable to undistributed corporate earnings while he was a shareholder. It then would be unnecessary to tax those earnings

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10 See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 8.02[3].

again when they are distributed to Buyer, who logically should be treated as receiving a return of capital rather than a $30 dividend.

In the early days of the income tax, taxpayers in Buyer's position argued that distributions out of preacquisition earnings should not be taxable since they did not represent any real gain to the shareholder. The Supreme Court put this argument to rest, reasoning:[11]

> Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation. The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him *ab extra,* and as constituting a part of his income when they came to hand.

Despite its conceptual flaws, the present approach is defensible on practical grounds. Since shares in publicly held corporations are traded daily, it would be difficult to determine precisely the corporation's earnings during the period that any particular shareholder held his stock. The current scheme at least ensures that earnings will be taxed to some shareholder, even if that shareholder may not be the theoretically correct one. Moreover, the presumption that distributions are made out of a corporation's earnings and profits to the extent they exist often eliminates the chore of tracing the source of a distribution and considerably simplifies the system.

2. QUALIFIED DIVIDENDS

Code: § 1(h)(11).

(h)(11)

For most of our tax history, dividends have been taxed as ordinary income. Relief from multiple taxation is provided to corporate shareholders by the Section 243 dividends received deduction. From time to time, individual shareholders also have received very modest relief from double taxation, most often in the form of a limited dividend exclusion that ranged from $50 to $400 before it was repealed in 1986.

As previewed in Chapter 1,[12] the double taxation of corporate earnings has been part of an ongoing tug of war over capital gains tax rates since the introduction of economic stimulus legislation in the early 2000s. One outcome of that debate was the historic decision to tax "qualified dividends" received since January 1, 2003 by noncorporate shareholders at the preferential long-term capital gains rates. Currently, this tax preference for dividends results in a top rate of 23.8 percent for

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11 Lynch v. Hornby, 247 U.S. 339, 343, 38 S.Ct. 543, 545 (1918).

12 See p. 6, supra.

high-income taxpayers (those above certain statutorily set levels of ordinary income). Lower qualified dividend tax rates of 18.8 percent, 15 percent, and zero percent apply to taxpayers who are taxable on ordinary income at rates below the high-income thresholds.[13] Technically, these preferential rates have been implemented by including "qualified dividend income" within the definition of "net capital gain" in Section 1(h), which provides for the maximum rate on long-term capital gains for noncorporate taxpayers.[14] The dividend rate reduction applies for both the regular tax and the individual alternative minimum tax.

To be eligible for the reduced rates, a dividend must be received from a domestic or foreign corporation that meets certain criteria.[15] But some income items that are labelled "dividends" do not qualify for the rate reduction. Familiar examples are credit union and money market fund dividends, "dividends" paid on hybrid corporate instruments (e.g., certain types of preferred stock that are treated as debt by the issuing corporation), and payments in lieu of dividends on stock that has loaned as part of a short sale transaction.[16] Corporate payors must identify which dividends are "qualified" on the Form 1099s that they send at the end of the year, but shareholders are responsible for determining if they comply with the holding period requirements discussed below.

To prevent arbitrage opportunities on short-term trades, the common stock with respect to which the dividend was paid must have been held by the taxpayer for more than 60 days in the 121-day period beginning 60 days before the stock's ex-dividend date.[17] The ex-dividend date is the first date on which a share with respect to which a dividend has been declared is sold without the buyer being entitled to the dividend.[18] Without this rule, a taxpayer could acquire stock shortly before becoming entitled to a dividend, sell the stock at a capital loss that could offset short-term capital gain or up to $3,000 of ordinary income if the taxpayer has no capital gains, but still pay tax on the dividend at the preferential rate. Several other rules have been included to prevent opportunistic exploitation of the rate reduction.[19]

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13 See I.R.C. § 1(j)(5). Note that some but not all taxpayers whose qualified dividends are taxed at 15 percent are subject to the extra 3.8 percent tax on net investment income.

14 I.R.C. § 1(h)(1), (11). Qualified dividends are subject to the preferential tax rates applicable to net capital gains but they are still ordinary income. Thus, qualified dividends may not be offset by capital losses without being subject to the $3,000 limitation in Section 1211(b).

15 I.R.C. § 1(h)(11)(B)(i).

16 I.R.C. § 1(h)(11)(B)(ii).

17 I.R.C. § 1(h)(11)(B)(iii), which imports, with some modifications, similar holding period limitations on the corporate dividends received deduction and requires a longer holding period (91 days during the 181-day period beginning 90 days before the ex-dividend date) for dividends paid with respect to preferred stock. See I.R.C. § 246 and Section F2 of this chapter, infra.

18 Under stock exchange rules, the ex-dividend date is typically three days before the date on which shareholders of record are entitled to receive a declared dividend.

19 See, e.g., I.R.C. § 1(h)(11)(D)(ii).

3. ECONOMIC IMPACT OF DIVIDEND RATE REDUCTIONS

Factors Influencing Corporate Dividend Policy. The distribution policies of closely held C corporations are often motivated by the goal of getting corporate profits to the shareholders at the lowest tax cost. For those shareholders, the issue is the comparative tax costs of: (1) dividends; (2) payments that are tax deductible by the corporation (e.g., salary, interest, and rent); and (3) transactions (such as redemptions) where shareholders can bail out earnings at capital gains rates.[20] Dividend policies of publicly traded corporations, on the other hand, vary widely. Most "old economy" companies adhere to the tradition of paying quarterly dividends, increasing them at regular intervals and rarely reducing their payouts unless the company is in serious financial difficulty. Many "new economy" companies, such as those in the technology sector, opt not to pay dividends, hoping instead to reward investors with increased share prices.

What is it that motivates public companies to pay dividends and to what extent do the tax laws influence corporate dividend policy? These questions have stimulated a lively theoretical debate.[21] One view is that companies pay dividends to serve as a signal to the financial markets of their profitability and future expectations,[22] enhancing shareholder value through their positive impact on the price of the stock. Beginning in the 1980s, however, and continuing through 2003, dividends became less fashionable. In explaining this decline, some corporate finance theorists explained that, apart from taxes and transaction costs, shareholders benefit more when a corporation deploys its available cash for business expansion, acquisition of other companies, or repurchases of its own stock. Under this theory, shareholders should be indifferent to a corporation's dividend policy because they reap the same benefit when the stock price increases to reflect undistributed earnings and they are free to generate "homemade dividends" by strategically timed sales of stock.[23] Throughout this debate, there also has been much discussion of the different interests of corporate managers and shareholders, and the potential "agency costs" when managers use retained earnings to make suboptimal investments or simply hoard cash.[24] Encouraging dividends is said to counteract this form of managerial empire building and imposes a measure of discipline. Returning the money to investors in the form of

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[20] See Chapters 1C & 3A, supra; Section E of this chapter, infra; and Chapter 5, infra.

[21] See generally Hamilton & Booth, Business Basics for Law Students: Essential Concepts and Applications § 12.11 (4th ed. 2006); Klein, Coffee & Partnoy, Business Organization and Finance, Legal and Economic Principles 395 et seq. (11th ed. 2010). For a historical perspective, see Bank, "Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History," 56 Tax L. Rev. 463 (2003).

[22] Hamilton, supra note 21, at § 12.12.

[23] See, e.g., Modigliani & Miller, "Dividend Policy, Growth, and the Valuation of Shares," 34 J. of Bus. 411 (1961), for an early articulation of the "dividend irrelevance" theory. See also Shaviro, Decoding the U.S. Corporate Tax 73–88 (2009).

[24] See, e.g., Easterbrook, "Two Agency-Cost Explanations of Dividends," 74 Am. Econ. Rev. 650 (1984).

dividends, so the argument goes, allows capital to be redirected more efficiently and promotes economic growth.[25]

Impact of Taxes on Dividend Payout. The dividend rate reductions introduced in 2003 provided an opportunity for economists to revisit the impact of taxes on corporate dividend policy. The traditional view is that the "double tax" on corporate profits lowers a shareholder's return on investment and encourages corporations to hoard cash, locking in huge stockpiles of capital that could be reinvested more efficiently if it were distributed and redeployed by shareholders. It follows from this thesis that lower tax rates will lead to higher dividends and new investments by the shareholders who receive them. Others contend that dividend tax cuts do not cause corporations to increase their payouts because their many institutional shareholders, such as pension funds and large charities, don't pay taxes. These contrarians also argue that since most new investments are made by corporations from retained earnings, dividend tax rate reductions are not an effective investment stimulus.

The evidence indicates that the dividend tax cuts did influence corporate behavior and contributed to at least a short-term increase in payouts by public companies. A dramatic early example was Microsoft Corporation's decision to distribute $32 billion as an extraordinary dividend at the end of 2004, use another $30 billion to repurchase stock over the next four years, and raise its modest quarterly dividend.[26] There also is evidence that dividends were initiated at corporations where stock was used as executive compensation to enable executives to benefit from the lower tax rates on qualified dividends.[27] More generally, several studies revealed that dividends rose sharply in the years following the rate reductions.[28] The percentage of public companies paying dividends began to increase in 2003 for the first time in more than two decades; many firms that had been paying regular dividends raised their payouts significantly after the tax cut; and a few companies such as Microsoft paid special one-time dividends.[29] A report issued by Standard and Poors at the end of 2004 supports the view that the combination of tax cuts and shareholder pressure contributed to a surge in dividend payments.[30] Empirical research also suggests that the dividend tax cuts affected investor behavior. While dividend income became more attractive for all taxable investors, the available data reveals that taxpayers in the

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25 See Moore & Kerpen, "Show Me the Money! Dividend Payouts after the Bush Tax Cut" (Cato Institute, Oct. 11, 2004).

26 Guth & Thurm, "Microsoft to Dole Out its Cash Hoard," Wall St. Journal, July 21, 2004, at A1.

27 Kawano, "Tax Policy and the Dividend Clientele Effect," 1 Penn Wharton Public Policy Initiative No. 10 (2013), available at http://publicpolicy.wharton.upenn.edu/issue-brief/v1n10.php.

28 Chetty & Saez, "Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Tax Cut," (NBER Working Paper 10572), available at www.nber.org/papers/w10572.

29 Id.

30 Opdyke, "Tax Cut, Shareholder Pressure Stoke Surge in Stock Dividends," Wall St. Journal, Jan. 18, 2005, at A1.

highest tax brackets were the most active in shifting their portfolios to increase dividend yields.[31]

Broader Economic Effects of Rate Reductions. The economic stimulus effects of what became known as "the Bush tax cuts" continue to be debated, with the usual suspects taking predictable political positions. One side argues that lower rates promote economic growth by increasing capital in the corporate sector and take a significant step toward removing taxes from important economic decisions. The counterpoint response is that tax cuts are not a principal contributor to economic activity and, if they do have any stimulative effect, it is short-lived.

The current state of dividend taxation has become relatively stable in the sense that the rules are no longer temporary. But policy decisions about capital gains rates and taxation of dividends are, in the end, political questions, so we always face the potential of being one election cycle away from possible change. Stay tuned.

B. EARNINGS AND PROFITS

Code: § 312(a), (c), (f)(1), (k)(1)–(3); 316(a). Skim § 312(n).

Regulations: §§ 1.312–6(a), (b), (d) (first sentence); 1.312–7(b)(1) (first sentence).

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316

The Code makes it clear that distributions are dividends only to the extent that they come from the corporation's earnings and profits, but it curiously does not take the extra step and actually define earnings and profits. Section 312 describes the effects of certain transactions on earnings and profits, and the accompanying regulations provide ample elaboration, but a precise definition of the term is nowhere to be found in the Code or regulations.[32] The function of the earnings and profits concept, however, is clear: it is a measuring device used to determine the extent to which a distribution is made from a corporation's economic income as opposed to its taxable income or paid-in capital.

The meaning of earnings and profits, which is a phrase peculiar to the tax law, has evolved over the years. It is roughly analogous (but not identical) to the accounting concept of retained earnings (sometimes called "earned surplus") in that neither amount includes initial paid-in capital or subsequent contributions to capital. The primary difference is that retained earnings are decreased by stock distributions and contingency reserves. If earnings and profits were similarly reduced, a company could avoid ever making a taxable distribution simply by ensuring that its distributions were preceded by nontaxable stock dividends or the establishment of reserves for contingencies. Earnings and profits also are not identical to taxable income. The earnings and

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[31] Kawano, supra note 27.

[32] For a history of the earnings and profits concept, see Rudick, " 'Dividends' and 'Earnings or Profits' Under the Income Tax Law: Corporate Non-Liquidating Distributions," 89 U. Pa. L. Rev. 865 (1941).

profits account is intended to measure the economic performance of the corporation. In contrast, taxable income does not provide a true financial picture because that concept is cluttered with a host of policy incentives and relief provisions that bear little or no relationship to the corporation's capacity to pay dividends.

Although earnings and profits can be determined by making adjustments to either retained earnings or taxable income, the traditional approach is to start with a corporation's taxable income and make adjustments that fall into the four broad categories discussed below. In general, the same accounting method used by the corporation to determine its taxable income is employed in determining earnings and profits.[33]

1. *Certain items excluded from taxable income must be added back.* Items that represent true financial gain but are exempt from tax, such as municipal bond interest, life insurance proceeds and federal tax refunds and otherwise excludable discharge of indebtedness income (unless coupled with a basis reduction under Section 1017) are included in earnings and profits.[34] Contributions to capital and gains that are realized but not recognized for tax purposes (e.g., like-kind exchanges, Section 351 transfers, involuntary conversions under Section 1033) are not added back in computing earnings and profits.[35]

2. *Certain items deductible in determining taxable income must be added back.* Certain deductions and benefits allowed in computing taxable income which do not reflect a real decrease in corporate wealth are not permitted or are restricted in determining earnings and profits. For example, a deductible item that involves no actual expenditure, such as the Section 243 dividends received deduction, must be added back to taxable income in determining earnings and profits. Similarly, the depletion allowance must be based on the corporation's cost of a depletable asset even if the corporation deducts percentage depletion in computing taxable income.[36]

3. *Certain nondeductible items must be subtracted.* Some items not allowed as deductions in computing taxable income in fact represent actual expenditures that diminish a corporation's capacity to pay dividends. These items reduce earnings and profits. For example, federal income taxes paid during the year by a cash method corporation will reduce earnings and profits,[37] as will losses and expenses disallowed

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33 Reg. § 1.312–6(a).

34 Reg. § 1.312–6(b). In the case of life insurance, the Service has ruled that earnings and profits are increased by the proceeds collected less the aggregate premiums paid by the corporation. Rev. Rul. 54–230, 1954–1 C.B. 114. For discharge of indebtedness income, see I.R.C. § 312(*l*)(1).

35 I.R.C. § 312(f)(1).

36 Reg. § 1.312–6(c).

37 Rev. Rul. 70–609, 1970–2 C.B. 78; Webb v. Commissioner, 572 F.2d 135 (5th Cir.1978). A few courts, however, have permitted a cash method corporation to reduce its earnings and

under provisions such as Sections 265 (expenses allocable to tax-exempt income), 267 (losses between related taxpayers) and 274 (travel and entertainment expenses) and charitable contributions in excess of the ten percent corporate limitation. In addition, net operating losses and capital losses in excess of capital gains reduce earnings and profits in the year they are incurred. In order to avoid a double tax benefit, they may not be carried back or forward in determining earnings and profits.

4. *Certain timing adjustments must be made.* Finally, a variety of adjustments are required to override timing rules that allow corporations to artificially defer income or accelerate deductions in computing taxable income.[38] For example, a corporation may not use the generally applicable accelerated cost recovery system (ACRS) of Section 168 in determining earnings and profits. Instead, the cost of depreciable property must be recovered in computing earnings and profits under the alternative depreciation system, which employs the straight line method using specially prescribed and generally longer recovery periods than ACRS.[39] This rule applies to property that is expensed under Section 168(k). The corporation thus must increase its taxable income by the excess accelerated depreciation allowed for tax purposes.[40] Under a slightly different rule with a similar purpose, if the corporation elects to expense the cost of eligible property under Section 179, it must amortize that expense ratably over five years in determining earnings and profits.[41] Additional earnings and profits timing rules require a corporation to capitalize otherwise amortizable construction period interest and taxes and to amortize normally deductible mineral exploration costs and intangible drilling expenses over extended time periods.[42]

On the income side, realized gains that are deferred for taxable income purposes under the installment sale method of Section 453 or by the completed contract method of accounting must be currently included in earnings and profits.[43] Moreover, for earnings and profits purposes, gains on the sale of inventory must be reported under the standard first-

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profits in the year to which the federal taxes relate even though the taxes have not yet been paid. See e.g., Drybrough v. Commissioner, 238 F.2d 735 (6th Cir.1956).

[38] See generally I.R.C. § 312(n). To prevent abuse of the dividends received deduction, the Section 312(n) adjustments do not apply to distributions to any 20 percent or more corporate shareholders. I.R.C. § 301(e). The effect of this rule is to reduce earnings and profits only in determining the amount of any dividend to major corporate shareholders. See Section F5 of this chapter, infra.

[39] I.R.C. §§ 312(k)(3)(A); 168(g)(2).

[40] The adjusted basis of the property determined under this special provision also is used in determining the impact of a sale or other disposition of property on earnings and profits. I.R.C. § 312(f)(1). In virtually all cases, this rule will cause corporations to have different bases in property for purposes of determining taxable income and earnings and profits.

[41] I.R.C. § 312(k)(3)(B).

[42] I.R.C. § 312(n)(1), (2).

[43] I.R.C. § 312(n)(5), (6).

in-first-out (FIFO) method rather than the last-in-first-out (LIFO) method.[44]

It should be apparent by now that earnings and profits is simply a tax accounting concept designed to better measure a corporation's true financial results. It is an artificial "account" created by the Code—not an actual bank account or liquid fund set aside by the corporation for the payment of dividends. There is no statute of limitations on earnings and profits issues, and a corporation sometimes will face the onerous task of reconstructing many years of financial history in order to determine the tax consequences of a current distribution.[45]

PROBLEM

X Corporation is a cash method, calendar year taxpayer. During the current year, X has the following income and expenses:

Gross profits from sales	$20,000
Salaries paid to employees	$10,250
Tax-exempt interest received	$ 3,000
Dividends received from IBM	$ 5,000
Depreciation (X purchased 5-year property in the current year for $7,000; assume the property was fully expensed under § 168(k))	$ 7,000
LTCG on a sale of stock	$ 2,500
LTCL on a sale of stock	$ 5,000
LTCL carryover from prior years	$ 1,000
Estimated federal income taxes paid	$ 800

Determine X's taxable income for the current year and its current earnings and profits.

C. DISTRIBUTIONS OF CASH

Code: §§ 301(a)–(c); 312(a); 316(a).

Regulations: §§ 1.301–1(a), (b); 1.316–2(a)–(c).

The taxation of cash distributions by a corporation with respect to its stock is relatively straightforward. The amount of the distribution is simply the amount of money received by the shareholder.[46] That amount is taxable as a dividend to the extent of the distributing corporation's

44 I.R.C. § 312(n)(4).

45 Because it usually is an inherently factual question, the Service will not issue a ruling on the amount of a corporation's earnings and profits. Rev. Proc. 2016–1, § 3.01(47), 2016–1 I.R.B. 129.

46 The same rule applies to corporate and noncorporate distributees. I.R.C. § 301(b).

current or accumulated earnings and profits.[47] Amounts distributed in excess of available earnings and profits are first applied against and reduce the basis of the shareholder's stock and, to the extent that they exceed the shareholder's basis, they are treated as gain from the sale or exchange of the stock.[48] The distributing corporation generally is permitted to reduce its earnings and profits by the amount of money distributed, except that earnings and profits may be reduced as a result of a distribution only to the extent they exist.[49] Thus, while a deficit in earnings and profits may result from corporate operations, a deficit may not be created or increased by a distribution.[50]

When there are insufficient current earnings and profits available to cover all cash distributions made during the year, earnings and profits must be allocated to the distributions in order to determine dividend status under the following rules:[51]

(1) First, current earnings and profits, determined as of the end of the year, are prorated among the distributions by using the following formula:[52]

$$\text{Current E \& P allocated to distribution} = \text{Amount of distribution} \times \frac{\text{Total current E \& P}}{\text{Total distributions}}$$

(2) Next, accumulated earnings and profits are allocated chronologically to distributions (i.e., on a first-come, first-served basis).[53]

(3) If the corporation has a current loss but has accumulated earnings and profits from prior years, it will be necessary to determine the amount of accumulated earnings and profits available on the date of distribution. Unless the loss can be earmarked to a particular period, the current deficit is prorated to the date of the distribution.[54]

Revenue Ruling 74–164, below, and the problem which follows test your ability to understand and apply these principles.

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47 I.R.C. §§ 301(c)(1); 316(a).

48 I.R.C. § 301(c)(2), (3).

49 I.R.C. § 312(a).

50 Id.

51 This allocation method is significant only if there is a change in shareholder interests during the year or on a non pro rata distribution.

52 Reg. § 1.316–2(b), (c) Example.

53 Id.

54 Reg. § 1.316–2(b).

Revenue Ruling 74–164

1974–1 Cum. Bull. 74.

Advice has been requested concerning the taxable status of corporate distributions under the circumstances described below.

X corporation and *Y* corporation each using the calendar year for Federal income tax purposes made distributions of $15,000 to their respective shareholders on July 1, 1971, and made no other distributions to their shareholders during the taxable year. The distributions were taxable as provided by section 301(c) of the Internal Revenue Code of 1954.

Situation 1

At the beginning of its taxable year 1971, *X* corporation had earnings and profits accumulated after February 28, 1913, of $40,000. It had an operating loss for the period January 1, 1971 through June 30, 1971, of $50,000 but had earnings and profits for the entire year 1971 of $5,000.

Situation 2

At the beginning of its taxable year 1971, *Y* corporation had a deficit in earnings and profits accumulated after February 28, 1913, of $60,000. Its net profits for the period January 1, 1971 through June 30, 1971, were $75,000 but its earnings and profits for the entire taxable year 1971 were only $5,000.

Situation 3

Assume the same facts as in *Situation* 1 except that *X* had a deficit in earnings and profits of $5,000 for the entire taxable year 1971.

Situation 4

Assume the same facts as in *Situation* 1 except that *X* had a deficit in earnings and profits of $55,000 for the entire taxable year 1971.

Section 301(a) and 301(c) of the Code provides, in part, that: (1) the portion of a distribution of property made by a corporation to a shareholder with respect to its stock which is a dividend (as defined in section 316), shall be included in the shareholder's gross income; (2) the portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock; and (3) the portion which is not a dividend to the extent that it exceeds the adjusted basis of the stock and is not out of increase in value accrued before March 1, 1913, shall be treated as gain from the sale or exchange of property.

Section 316(a) of the Code provides that the term "dividend" means any distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year computed as of the close of the taxable year without diminution by reason of any distribution made during the year, and *without regard to the amount of earnings and profits at the time the distribution was made.*

Section 1.316–2(a) of the Income Tax Regulations provides, in part, that in determining the source of a distribution, consideration should be given first, to the earnings and profits of the taxable year; and second, to the earnings and profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings and profits of that year.

Applying the foregoing principles, in *Situation 1*, the earnings and profits of *X* corporation for the taxable year 1971 of $5,000 and the earnings and profits accumulated since February 28, 1913, and prior to the taxable year 1971, of $40,000 were applicable to the distribution paid by it on July 1, 1971. Thus, $5,000 of the distribution of $15,000 was paid from the earnings and profits of the taxable year 1971 and the balance of $10,000 was paid from the earnings and profits accumulated since February 28, 1913. Therefore, the entire distribution of $15,000 was a dividend within the meaning of section 316 of the Code.

In *Situation 2* the earnings and profits of *Y* corporation for the taxable year 1971 of $5,000 were applicable to the distribution paid by *Y* corporation on July 1, 1971. *Y* corporation had no earnings and profits accumulated after February 28, 1913, available at the time of the distribution. Thus, only $5,000 of the distribution by *Y* corporation of $15,000 was a dividend within the meaning of section 316 of the Code. The balance of such distribution, $10,000 which was not a dividend, applied against and reduced the adjusted basis of the stock in the hands of the shareholders, and to the extent that it exceeded the adjusted basis of the stock was gain from the sale or exchange of property.

In the case of a deficit in earnings and profits for the taxable year in which distributions are made, the taxable status of distributions is dependent upon the amount of earnings and profits accumulated since February 28, 1913, and available at the dates of distribution. In determining the amount of such earnings and profits, section 1.316–2(b) of the regulations provides, in effect, that the deficit in earnings and profits of the taxable year will be prorated to the dates of distribution.

Applying the foregoing to Situations 3 and 4 the distribution paid by *X* corporation on July 1, 1971, in each situation was a dividend within the meaning of section 316 of the Code to the extent indicated as follows:

Situation #3

Accumulated Earnings and Profits (E & P) 1/1	$40,000
E & P deficit for entire taxable year ($5,000) Prorate to date of distribution 7/1 (½ of $5,000)	(2,500)
E & P available 7/1	$37,500

Distribution 7/1 ($15,000)	(15,000)	taxable as a dividend
E & P deficit from 7/1–12/31	(2,500)	
Accumulated E & P balance 12/31	$20,000	
Situation #4		
Accumulated E & P 1/1	$40,000	
E & P deficit for entire taxable year ($55,000) Prorate to date of distribution 7/1 (½ of $55,000)	(27,500)	
E & P available 7/1	$12,500	
Distribution 7/1 ($15,000)	(12,500)	taxable as a dividend
E & P deficit from 7/1–12/31	(27,500)	
Accumulated E & P balance 12/31	$(27,500)	

NOTE

Earmarking E & P Deficits. Situations 3 and 4 of Revenue Ruling 74–164 do not consider the possibility of earmarking the entire 1971 deficit (i.e., $5,000 in Situation 3 and $55,000 in Situation 4) to the first half of the year. Under the regulations,[55] if those deficits were sustained in the first half of 1971, the full deficit (not just one-half) would reduce the accumulated earnings and profits available to characterize the July 1 distribution as a dividend. This would not affect the result in Situation 3 but it would change Situation 4, where there would be no dividend.

Return of Capital Distributions and Multiple Tax Lots. The tax treatment of return of capital distributions from C corporations to shareholders who hold multiple "tax lots" of stock has never been crystal clear. If a distribution is not a dividend, Section 301(c)(2) first requires a reduction of stock basis and, once basis is reduced to zero, Section 301(c)(3) treats the remainder of the distribution as gain from the sale of the stock (usually capital gain). If a shareholder has more than one block of stock and the blocks have different per-share bases, the question has been whether the shareholder recovers his aggregate basis before recognizing gain, or whether the distribution must be allocated pro rata to each share of stock. If an allocation is required, the possibility arises that a shareholder will recognize gain on low basis shares even though the basis of the high basis shares has not been fully recovered.

Regulations that were proposed and later withdrawn would have answered this question by requiring the nondividend portion of a distribution to be allocated pro rata, on a share-by-share basis, to reduce the adjusted basis of each block of stock held by the shareholder within the class of stock upon which the distribution is made. The proposed regulations were withdrawn because the Treasury concluded that they could not be implemented without significant modifications. The IRS, however, indicated

55 Reg. § 1.316–2(b).

that it continues to believe that under current law, the results of a section 301 distribution should be based on the consideration received by a shareholder in respect of each share of stock, notwithstanding designations otherwise.[56]

PROBLEM

Ann owns all of the common stock (the only class outstanding) of Pelican Corporation. Prior to the transactions below and as a result of a § 351 transfer, Ann has a $10,000 basis in her Pelican stock. What results to Ann and Pelican in each of the following alternative situations?

(a) In year one Pelican has $5,000 of current and no accumulated earnings and profits and it distributes $17,500 to Ann?

(b) Pelican has a $15,000 accumulated deficit in its earnings and profits at the beginning of year two. In year two Pelican has $10,000 of current earnings and profits and it distributes $10,000 to Ann.

(c) Pelican has $10,000 of accumulated earnings and profits at the beginning of year two and $4,000 of current earnings and profits in year two. On July 1 of year two, Ann sells half of her Pelican stock to Baker Corporation for $15,000. On April 1 of year two, Pelican distributes $10,000 to Ann, and on October 1 of year 2, Pelican distributes $5,000 to Ann and $5,000 to Baker.

(d) Same as (c), above, except that Pelican has a $10,000 deficit in earnings and profits in year 2 as a result of its business operations.

D. DISTRIBUTIONS OF PROPERTY

1. CONSEQUENCES TO THE DISTRIBUTING CORPORATION

a. BACKGROUND: THE *GENERAL UTILITIES* DOCTRINE

Under the double tax regime of Subchapter C, profits from the sale of appreciated corporate property are taxed twice—first to the corporation when it sells the property and again to the shareholders when the sales proceeds are distributed as dividends. What if a corporation *distributes* appreciated property to its shareholders? The shareholders, of course, receive a taxable dividend to the extent the distribution is out of current or accumulated earnings and profits. Should the distributing corporation also recognize gain—just as if it had sold the property for its fair market value? Or is the corporation entitled to nonrecognition of gain because the property was distributed rather than sold? Does the answer depend on the shareholder's basis in the distributed property? If tax relief is appropriate, should nonliquidating

[56] REG–143686–07 (Mar. 28, 2019).

distributions be treated less favorably than liquidating distributions? And what about distributions of loss property? Simple as they may seem, these are among the most controversial questions ever spawned by Subchapter C. The answers will come gradually. The coverage in this chapter is limited to nonliquidating distributions. To set the stage, we begin with a brief history of the rise and fall of what became known as the *General Utilities* doctrine.

In General Utilities & Operating Co. v. Helvering,[57] the Supreme Court first considered the corporate-level tax consequences of a nonliquidating distribution of appreciated property by a corporation to its shareholders. The facts were straightforward. General Utilities Corporation had located a buyer for corporate property with a value of $1,000,000 and an adjusted basis of $2,000. Hoping to escape the large corporate-level tax that would be imposed on a sale by the corporation, General Utilities distributed the property to its shareholders with an "understanding" (but not a legal commitment) that they would sell the targeted property to the prospective buyer. Four days later, the shareholders sold the property to the buyer on the same terms negotiated by the corporation. The Service contended that the distribution was a taxable event at the corporate level.

By the time the controversy reached the Supreme Court, the government's principal argument was based on the premise that General Utilities had created an indebtedness to its shareholders by declaring a dividend. It went on to contend that using appreciated property to discharge that indebtedness was a taxable event. Apparently confining its decision to these narrow grounds, the Court held that the corporation recognized no gain because the distribution was not a "sale" and the corporation did not discharge indebtedness with appreciated assets.[58] Despite this limited holding, it long was assumed that *General Utilities* stood for the broader proposition that a distributing corporation does not recognize gain or loss when it makes a distribution in kind with respect to its stock.[59]

The result in *General Utilities* raised fundamental policy questions that went to the heart of the double tax regime. The decision created a significant and arguably unwarranted tax distinction between a

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57 296 U.S. 200, 56 S.Ct. 185 (1935).

58 The government also argued that the subsequent sale by the shareholders of the assets could be attributed to the corporation, but the Court declined to consider that question since it had not been raised below. Ten years later, in Commissioner v. Court Holding Co., 324 U.S. 331, 65 S.Ct. 707 (1945), the government successfully advanced the attribution argument in the context of a liquidating distribution. See Chapter 7B2, infra. In *General Utilities*, the government alternatively contended that a distribution of appreciated property by a corporation in and of itself constitutes a realization event, but the Court did not address this argument. See Bittker & Eustice, supra note 10, ¶ 8.20[2].

59 See, e.g., Commissioner v. Godley's Estate, 213 F.2d 529, 531 (3d Cir.1954), cert. denied 348 U.S. 862, 75 S.Ct. 86 (1954). Even before the 1954 Code, however, the *General Utilities* nonrecognition rule was subject to judicially-created exceptions, such as the assignment of income doctrine. See S.Rep. No. 1622, 83rd Cong., 2d Sess. 247 (1954).

distribution in kind of appreciated property and a sale of that same property by the corporation followed by a distribution of the proceeds to the shareholders. In the case of a sale at the corporate level, the corporation recognizes gain and correspondingly must increase its earnings and profits. On distribution of the sale proceeds, the shareholders also are taxed to the extent of the corporation's earnings and profits. Under *General Utilities,* however, the corporation could distribute the same asset to the shareholders without recognizing gain. Although the shareholders were taxable on the distribution, the asset appreciation escaped tax at the corporate level, and a noncorporate shareholder took the asset with a fair market value basis.[60] This simple comparison demonstrates that the tax treatment of distributions in kind is critical to the integrity of the double tax regime. Because the *General Utilities* doctrine was incompatible with the double tax, it was criticized by commentators.[61]

Despite these deficiencies, Congress codified *General Utilities* in the 1954 Code by enacting Section 311(a)(2), which provides that a corporation generally does not recognize gain or loss on a nonliquidating distribution of property.[62] This nonrecognition rule was never absolute. Over the years, the courts applied "common law" doctrines, such as assignment of income[63] and the tax benefit rule,[64] and substance over form,[65] to override Section 311(a) and attribute income back to the corporation. Congress also chipped away at the doctrine with various specialized statutory exceptions until 1986, when it repealed *General Utilities* in the context of both nonliquidating and liquidating distributions of appreciated property.[66]

b. CORPORATE GAIN OR LOSS

Code: § 311.

Although the nonrecognition rule in Section 311(a)(2) remains in the Code, Section 311(b) stands that rule on its head for nonliquidating distributions of appreciated property. If a corporation distributes appreciated property (other than its own obligations) in a nonliquidating distribution, it must recognize gain in an amount equal to the excess of the fair market value of the property over its adjusted basis. If the

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60 I.R.C. § 301(d).

61 See, e.g., Blum, "Taxing Transfers of Incorporated Business: A Proposal for Improvement," 52 Taxes 516 (1974); Raum, "Dividends in Kind: Their Tax Aspects," 63 Harv. L. Rev. 593 (1950).

62 Prior to 1987, Section 336 provided a similar nonrecognition rule for liquidating distributions. See Chapter 7B2, infra.

63 See, e.g., Commissioner v. First State Bank of Stratford, 168 F.2d 1004 (5th Cir.1948), cert. denied, 335 U.S. 867, 69 S.Ct. 137 (1948).

64 Cf. Hillsboro National Bank v. Commissioner, 460 U.S. 370, 103 S.Ct. 1134 (1983).

65 Bush Brothers & Co. v. Commissioner, 668 F.2d 252 (6th Cir.1982); Waltham Netoco Theatres, Inc. v. Commissioner, 401 F.2d 333 (1st Cir.1968). But see Anderson v. Commissioner, 92 T.C. 138 (1989).

66 See also Chapter 7B2, infra.

distributed property is subject to a liability or if the distributee shareholder assumes a liability in connection with the distribution, the fair market value of the distributed property is treated as not less than the amount of the liability.[67] The deceptive "general" rule of Section 311(a)(2) still applies, however, to disallow recognition of loss on a distribution of property that has declined in value. The objective of this statutory regime is to strengthen the corporate income tax by ensuring that appreciated property may not leave corporate solution and take a stepped-up basis in the hands of the distributee shareholder without the imposition of a corporate-level tax on the appreciation.[68]

The *General Utilities* doctrine thus no longer applies to nonliquidating distributions of appreciated property. A later chapter examines the repeal of the doctrine in the area of complete liquidations.[69] Despite what appears to be parallel treatment, some differences between the treatment of liquidating and nonliquidating distributions persist, raising lingering policy issues. For example, a distributing corporation generally may recognize a loss on a liquidating distribution of property with a built-in loss.[70] Should nonliquidating distributions be treated similarly? Is the "general" loss disallowance rule in Section 311(a)(2) an indefensible trap for the uninformed? In considering these questions, one should keep in mind that the double tax regime is not universally accepted, and some commentators once argued that relief through limited *General Utilities* type exceptions would be appropriate.[71]

c. EFFECT ON THE DISTRIBUTING CORPORATION'S EARNINGS AND PROFITS

Code: § 312(a)(3), (b), (c), (f)(1).

Regulations: § 1.312–3.

Nonliquidating distributions of property have several effects upon the earnings and profits of the distributing corporation. Gain recognized by the corporation on the distribution naturally increases current earnings and profits.[72] Following a property distribution, the distributing corporation may reduce accumulated earnings and profits (to the extent thereof) under Section 312(a)(3) by the adjusted basis of the distributed

67 I.R.C. § 311(b)(2), incorporating the rule for liquidating distributions in I.R.C. § 336(b). 336(b).

68 Cf. S.Rep.No. 98–169, 98th Cong., 2d Sess. 177 (1984); H.R.Rep.No. 99–426, 99th Cong., 1st Sess. 282 (1985).

69 See Chapter 7B2, infra.

70 I.R.C. § 336(a), (d).

71 Compare Thompson, "An Analysis of the Proposal to Repeal General Utilities with an Escape Hatch," 31 Tax Notes 1121 (June 16, 1986) with Yin, "General Utilities Repeal: Is Tax Reform Really Going to Pass it By?" 31 Tax Notes 1111 (June 16, 1986).

72 I.R.C. § 312(b)(1), (f)(1). For this purpose and for purposes of determining gain recognized, the adjusted basis of any property is its adjusted basis for purposes of computing earnings and profits. I.R.C. § 312(b), flush language. For example, tangible property depreciated for tax purposes under the accelerated cost recovery system must be depreciated for "E & P" purposes under the § 168(g)(2) alternative depreciation system and thus may have a different "E & P" adjusted basis.

property. On a distribution of appreciated property (other than a corporation's own debt obligations), this rule is modified by Section 312(b)(2), which provides that the earnings and profits reduction rule in Section 312(a)(3) is applied by substituting the fair market value of the property for its adjusted basis. This special rule logically allows a corporation distributing appreciated property to make a downward adjustment to accumulated earnings and profits in an amount equal to the full fair market value of the property. The net result of these earnings and profits adjustments—the first relating to the gain recognized on the distribution and the second relating to the effect of the distribution itself—is the same as if the corporation had sold the property (increasing current earnings and profits by the gain recognized) and then distributed cash equal to the fair market value of the property (decreasing accumulated earnings and profits by that amount).

Section 312(c) cryptically adds that "proper adjustment" shall be made for liabilities either assumed by the shareholder or to which the property is subject. Section 1.312–3 of the regulations provides that the "proper adjustment" is a reduction in the Section 312(a)(3) charge to earnings and profits for liabilities assumed or to which the property is subject. This adjustment thus *decreases* the charge to earnings and profits and properly reflects the fact that relief from the liability is an economic benefit to the distributing corporation.

d. DISTRIBUTIONS OF A CORPORATION'S OWN OBLIGATIONS

Code: §§ 311(a), (b)(1); 312(a)(2).

Regulations: § 1.301–1(d)(1)(ii).

By virtue of the parenthetical in Section 311(b)(1)(A), "(other than an obligation of such corporation)", the general gain recognition rule does not apply to distributions by a corporation of its own debt obligations. Consequently, the eroded Section 311(a) continues to govern this situation. At the shareholder level, both the amount of the distribution and the distributee shareholder's basis are equal to the fair market value of the obligation.[73] The distributing corporation's earnings and profits are reduced by the principal amount of the obligation or, in the case of an obligation having original issue discount, by its issue price.[74]

2. CONSEQUENCES TO THE SHAREHOLDERS

Code: § 301(a)–(d).

The rules governing the shareholder level tax consequences of property distributions are essentially the same as those for cash distributions. The amount of the distribution is the fair market value of the distributed property, reduced by any liabilities assumed by the

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[73] Reg. §§ 1.301–1(d)(1)(ii), –1(h)(2)(i).

[74] I.R.C. § 312(a)(2).

shareholder or to which the property is subject;[75] that amount is taxed under the now familiar principles in Section 301(c). The shareholder's basis in the distributed property is its fair market value as of the date of the distribution.[76]

PROBLEM

Zane, an individual, owns all of the outstanding common stock in Sturdley Utilities Corporation. Zane purchased his Sturdley stock seven years ago and his basis is $8,000. At the beginning of the current year, Sturdley had $25,000 of accumulated earnings and profits and no current earnings and profits. Determine the tax consequences to Zane and Sturdley in each of the following alternative situations:

(a) Sturdley distributes inventory ($20,000 fair market value; $11,000 basis) to Zane.

(b) Same as (a), above, except that, before the distribution, Sturdley has no current or accumulated earnings and profits.

(c) Sturdley distributes land ($20,000 fair market value; $11,000 basis) which it has used in its business. Zane takes the land subject to a $16,000 mortgage.

(d) Assume Sturdley has $15,000 of current earnings and profits (in addition to $25,000 of accumulated earnings and profits) and it distributes to Zane land ($20,000 fair market value; $30,000 basis) which it held as an investment. Compare the result if Sturdley first sold the land and then distributed the proceeds.

(e) Assume again that Sturdley has $25,000 of accumulated earnings and profits at the beginning of the current year. Sturdley distributes machinery used in its business ($10,000 fair market value, zero adjusted basis for taxable income purposes, and $2,000 adjusted basis for earnings and profits purposes). The machinery is five-year property and has a seven-year class life, was purchased by Sturdley for $14,000 on July 1 of year one when it was fully expensed under § 168(k), and the distribution is made on January 1 of year seven. See I.R.C. §§ 168(g)(2), 312(k)(3); Reg. § 1.312–15(d). E&P.

E. CONSTRUCTIVE DISTRIBUTIONS

Code: Skim § 7872(a), (c)(1)(C).

Regulations: § 1.301–1(j).

Historically, dividend distributions often combined the worst of all possible worlds from a tax standpoint: they were fully taxable to noncorporate shareholders at the highest ordinary income rates but were

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75 I.R.C. § 301(b). The fair market value of the distributed property is determined as of the date of distribution. I.R.C. § 301(b)(3).

76 I.R.C. § 301(d).

not deductible by the distributing corporation. To avoid the double tax, closely held C corporations have attempted to distribute earnings in a form that may be deductible at the corporate level. Notable examples include a corporation's payment of: (1) excessive compensation to shareholders or their relatives;[77] (2) expenses paid for the personal benefit of shareholders (e.g., travel or entertainment, legal expenses);[78] (3) excessive rent for corporate use of shareholder property;[79] and (4) interest on shareholder debt that in substance represents equity.[80] If these payments are not what they purport to be—i.e., if they are not *really* salary, rent or interest, etc., or if they are primarily for the personal benefit of shareholders—they risk being reclassified by the Service as a constructive dividend. In that event, the corporate level deduction will be disallowed. Other disguised dividend strategies include labeling what in reality is a distribution as a loan to the shareholder,[81] bargain sales or rentals of corporate property to shareholders[82] and interest free loans.[83]

The constructive dividend area has produced many entertaining controversies involving blatant attempts by taxpayers to milk their corporations while avoiding the double tax. The prototype transaction involves a direct payment or receipt of an economic benefit by the shareholder, and resolution of the issue requires an evaluation of all the facts and circumstances, applying broad standards such as "reasonable compensation;" "shareholder benefit vs. corporate benefit" and "intent."[84] The case below illustrates a typical fact pattern. It is followed by a Note discussing the changing stakes now that the corporate tax rate has been reduced to 21 percent and most dividends are taxed at a preferential rate.

Nicholls, North, Buse Co. v. Commissioner

United States Tax Court, 1971.
56 T.C. 1225.

[Nicholls, North, Buse Co. ("Nicholls") was a Wisconsin corporation in the food-brokerage and food-packing businesses. All of the Nicholls voting common stock was owned by Herbert and Charlotte Resenhoeft, who were married. Herbert served as president and a director of the

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[77] For the legal standards used in making this determination, see, e.g., Menard, Inc. v. Commissioner, 560 F.3d 620 (7th Cir. 2009), and compare Charles McCandless Tile Service v. United States, 191 Ct.Cl. 108, 422 F.2d 1336 (1970) with Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir.1983).

[78] See, e.g., Ashby v. Commissioner, 50 T.C. 409 (1968); Hood v. Commissioner, 115 T.C. 172 (2000).

[79] See, e.g., International Artists, Ltd. v. Commissioner, 55 T.C. 94 (1970).

[80] See Chapter 3, supra.

[81] See, e.g., Williams v. Commissioner, 627 F.2d 1032 (10th Cir.1980).

[82] See, e.g., Honigman v. Commissioner, 466 F.2d 69 (6th Cir.1972).

[83] Compare Zager v. Commissioner, 72 T.C. 1009 (1979) with I.R.C. § 7872. See also Rountree Cotton Co. v. Commissioner, 113 T.C. 422 (1999), aff'd by order, 12 Fed.Appx. 641 (10th Cir.2001).

[84] See generally, Bittker & Eustice, supra note 10, ¶ 8.06.

corporation. Nicholls nonvoting common stock was owned by Herbert, Charlotte and their two sons, Robert and James. James was also an employee of Nicholls.

Herbert Resenhoeft previously had personally owned two boats: *Pea Picker I* and *Pea Picker II*. In 1964, Nicholls acquired a new 52-foot yacht—*Pea Picker III*—at a total cost of $68,290. Nicholls' Board of Directors unanimously approved the purchase of *Pea Picker III* and provided in a corporate resolution that "any expenses incurred in the personal use of the boat are to be borne by H.A. Resenhoeft and an accurate log is to be kept of all business use." During 1964, $1,144.72 was charged to Herbert for personal use of *Pea Picker III*.

Both Robert and James were free to operate *Pea Picker III*, without special permission. Herbert was unable to operate the yacht and had little technical knowledge about yachting. James was the principal operator of *Pea Picker III* and was the family boating enthusiast. In fact, James negotiated Nicholls' purchase of the yacht. During 1964, the use of *Pea Picker III* included personal use by James.

In its original notice of deficiency to Herbert, the Service took the position that he was taxable on $68,878.72, the purchase price for the yacht plus yacht expenses for the year. Later, the Service alternatively argued that Herbert was taxable on a dividend equal to the fair rental value of *Pea Picker III*. Ed.]

The issues with regard to individual petitioner Resenhoeft resolve themselves down to the following: (a) Was there a constructive dividend; (b) may the use of the yacht by James, a stockholder in his own right, be imputed to his father who was in control of the corporation to make the father the recipient of the constructive dividend; and (c) is the measure of the dividend the purchase price of the craft plus actual operating expenses or is the fair rental value of the use of the yacht during the period in question the appropriate measure?

(a) It is well established that any expenditure made by a corporation for the personal benefit of its stockholders, or the making available of corporate-owned facilities to stockholders for their personal benefit, may result in the receipt by the stockholders of a constructive dividend. * * * Upon consideration of all the evidence, including the possible instances of unrecorded personal use, we conclude that *Pea Picker III* was used for business purposes 25 percent and for personal purposes 75 percent of the time in 1964.

(b) Since we have found that there was personal use constituting under some circumstances a dividend, the next question is, to whom was the benefit directed? Resenhoeft has established by convincing evidence that he was not interested in the yacht for his own personal pleasure as a boating enthusiast. He had little knowledge of the workings of such craft, could not operate them himself, and played no direct part in the purchase of *Pea Picker III* or the sale of her predecessor. However, to the extent that he was present on an occasion of personal use, he received a benefit and an argument that others benefited as well is of no avail here. * * * He shared in the friendships and joined in the social activity on board on those occasions.

The question remains, however, whether James' personal use of *Pea Picker III* on occasions when Resenhoeft was not present may nevertheless be attributed to Resenhoeft. The essential elements underlying the taxation of assigned income to the assignor were set down in Helvering v. Horst, 311 U.S. 112 (1940). The Court stated in that case that: "The power to dispose of income is the equivalent of 'ownership' of it and the exercise of that power to procure the payment of income to another is the 'enjoyment' and hence the 'realization' of the income by him who exercises it." In this case Resenhoeft personally owned well over 50 percent of all voting stock and together with his wife owned all of it, and in addition was the president of the company and on the board of directors. It is manifestly clear that it was Resenhoeft's decision that the corporation acquire *Pea Picker III*. Resenhoeft's decision to allow the use of the boat by his sons as they desired and without direct control over either the circumstances of use or the maintenance of appropriate supportive documentation must be given particular emphasis. There is no indication here that information regarding the actual use of the boat, or the type of records maintained, was being kept from Resenhoeft or that he had no way of learning the truth. * * *

The principle of assignment was applied to constructive dividends in Byers v. Commissioner, 199 F.2d 273 (C.A.8, 1952), certiorari denied 345 U.S. 907 (1953). See also Commissioner v. Makransky, 321 F.2d 598 (C.A.3, 1963). We remain unpersuaded that Resenhoeft's purpose in agreeing to the acquisition of a large pleasure craft was only to benefit the corporation. This is particularly so in light of his prior personal ownership of *Pea Picker I* and *II* which were available for the use and benefit of his sons. Once it is understood that Resenhoeft was in complete control of the events, the fact that James, the principle user of the boat for noncorporate purposes, was a mature adult and a shareholder in his own right becomes irrelevant.

(c) Although we have determined that there was a dividend, and that the dividend must be attributed to Resenhoeft, we have yet to ascertain the amount of the dividend. Two standards have been used on different occasions, the first being the initial cost of the facility and the second, the approximate rental value for the period at issue. The standard to be chosen rests on the facts and circumstances of the event rather than on which year (the initial year of purchase or a subsequent year) happens to be before the Court, as was argued by respondent in his briefs. In *Louis Greenspon, supra*, the Court held that continued corporate ownership of farm equipment used by the petitioner shareholder prevented the assessment of a constructive dividend based on the purchase price of the equipment. No determination of a dividend was made based on the rental value since respondent failed to raise that issue. Our holding in *Greenspon* that ownership of the asset is a principal factor has not been altered by subsequent cases involving the year an asset was acquired. Although in some cases subsequent to *Greenspon* we have determined the amount of the dividend to be the acquisition cost, in those cases the evidence clearly pointed to shareholder ownership, * * * or the location of title could not be determined and therefore was presumptively in the shareholder. * * * These cases have not been followed when the title was clearly with the corporation. * * *

In this case, ownership continued to rest with Nicholls. The bill of sale was made in Nicholls' name, Nicholls' principal creditor was informed of the purchase and the yacht's intended devotion to corporate purposes, a license to operate short-wave radio equipment installed on *Pea Picker III* was acquired in the corporate name, registration by U.S. Customs was attempted in the corporate name, registration and licensing was received from the State of Wisconsin in the corporate name, and sales tax was paid by the corporation although a significant savings would have resulted by treating this as a purchase by Resenhoeft. Although a listing in the Lake Michigan Yachting Association catalogue showed James as the owner of the *Pea Picker III*, the association provided no means for noting corporate ownership, and registration in whatever name offered values significant to the corporation as well as to James. Therefore we hold that petitioner has not received a constructive dividend equivalent to the cost of acquisition of *Pea Picker III*.

The issue yet remaining is whether there is another more appropriate measure of the constructive dividend, a dividend which we have already decided Resenhoeft received.

Respondent's alternative theory is that the fair rental value of *Pea Picker III* for the period of use in 1964 is the measure of the dividend received; furthermore, respondent argues that the testimony of the captain in charge of delivering *Pea Picker III* from Florida corroborates the minimum rental value alleged in respondent's amended answer. The amended answer alleged that the fair value was not less than Nicholls' combined depreciation and operating expenses, $4,578.86, of which $1,144.72 concededly was included as income by Resenhoeft at the time he filed his 1964 return. Since we have already determined that Resenhoeft should be charged with 75 percent of the total value of the use of the yacht rather than 100 percent as argued by respondent, the remaining amount actually in dispute is $2,289.42. * * *

Ordinarily, respondent's alternative allegation would be determinative since petitioner has offered no evidence showing that determination to be in error. However, since the theory of a dividend based on rental value comprises a separate issue, involving distinct factual questions, and was raised by the Commissioner for the first time in his amended answer, the rental value suggested by the Commissioner may not be given the presumption it would otherwise be due * * * . Upon considering all evidence, including the rental value of similar craft used in dissimilar water, we hold that the full rental value of *Pea Picker III* for the period following the shakedown cruise and ending with the final storage of the boat was $4,000. Resenhoeft gained personal benefit and therefore received a constructive dividend from his own use and the use of the craft by his sons equaling 75 percent of the above rental value; of that amount he has voluntarily recognized income to the extent of $1,144.72. We have no reason to believe Nicholls' earnings and profits were insufficient for the payment of a taxable dividend of the amount determined above.

* * *

NOTE

Payment of deductible expenses by a C corporation to its shareholders has been one of the classic strategies to escape the double taxation of corporate income. The effectiveness of that strategy, however, was diminished by the reduction in the top corporate tax rate from 35 to 21 percent in the Tax Cuts and Jobs Act. A payment that is deductible by the corporation now saves only a 21 percent tax on the amount of income leaving the corporate coffers. This change upends, or at least significantly neutralizes, many of the time-tested tax saving plans that were historically employed by closely held corporations.

To understand the effect of the reduced corporate tax rate on these venerable strategies, assume a C corporation has $100,000 of taxable income that its sole shareholder wishes to withdraw from the business at the lowest possible tax cost. If a dividend is contemplated, the corporation will first pay a 21 percent corporate tax ($21,000), leaving $79,000 for distribution as a dividend. The shareholder will be taxed on the $79,000 dividend at either a 15 percent, 18.8 percent, or 23.8 percent rate.[85] The 18.8 percent qualified dividend rate begins to apply to individuals at $200,000 of modified adjusted gross income ($250,000 in the case of married taxpayers filing jointly).[86] In 2019, the 23.8 percent dividend rate begins to apply at $434,550 of taxable income for an individual taxpayer ($488,850 in the case of a married taxpayer filing jointly).[87] After combining the 21 percent corporate rate and the applicable shareholder dividend rate, the total tax rate on the $100,000 of income will be either 32.85 percent, 35.85 percent or 39.8 percent.[88]

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[85] The discussion disregards the possibility of a zero tax for dividends for certain lower income taxpayers, takes into account the 3.8 percent tax on net investment income, and ignores state taxes. See I.R.C. §§ 1(j)(5)(A)(i), (B)(i); 1411.

[86] I.R.C. § 1411(a)(1), (b) & (c). For purposes of the 3.8 percent net investment income tax, "modified" adjusted gross income means adjusted gross income increased by certain items related to the exclusion in Section 911 for foreign earned income. I.R.C. § 1411(d).

[87] I.R.C. § 1(j)(5)(A)(ii), (B)(ii); see Rev. Proc. 2018–57, § 3.03, 2018–49 I.R.B. 827.

[88] In each case, the corporate tax is $21,000. At the various dividend tax rates, the respective shareholder-level taxes on the $79,000 dividend are: $11,850 (15% x $79,000), $14,852 (18.8% x $79,000), or $18,802 (23.8% x $79,000). The combined taxes are thus $32,850 ($21,000 + $11,850), $35,852 ($21,000 + $14,852), or $39,802 ($21,000 + $18,802).

The next question for the shareholder is whether it is possible to reduce the total tax cost in this simple example by, instead, having the corporation make a $100,000 tax-deductible payment to the shareholder in some other capacity (e.g., lender or lessor) of, say, interest or rent? Since the corporate tax is eliminated by the deductible payment, the answer depends on the total tax owed by the shareholder on the $100,000 of income. Determination of the shareholder's tax results raises additional issues depending on the form of the payment. In 2019, single individuals begin paying tax at a 32 percent rate on taxable income above $160,725, and married taxpayers filing jointly reach the 32 percent marginal tax rate on taxable income above $321,450. The 35 percent marginal tax rate begins to apply to taxable income greater than $204,100 (for single taxpayers) and $408,200 (for married filing jointly). And a 37 percent marginal tax rate is possible for taxpayers with even higher levels of taxable income. Note that the tax rates on ordinary income generally do not correlate to the income levels for increases in the tax rates for dividends.[89] In addition, the 3.8 percent tax on net investment income begins to apply above a $200,000 modified adjusted gross income threshold amount for singles and a $250,000 threshold amount for married taxpayers filing jointly. Another potential complication is whether the payment received by the shareholder may potentially be eligible for the Section 199A deduction for qualified business income, thereby possibly saving 20 percent of the tax owed on the payment.

If you get the sense that there are a lot of "moving parts" to this analysis, join the crowd. Are there any generalizations that can be made? Perhaps a few. First, at high income levels, if the taxpayer owes the additional 3.8 percent tax on net investment income (for example, on a payment of interest), the total shareholder tax rate likely will be 35.8 percent (32 percent plus 3.8 percent) or higher (up to 40.8 percent (37 percent plus 3.8 percent)), and it will be difficult, if not impossible, to significantly improve on the overall tax results by having the corporation make a tax-deductible payment rather that distributing dividends. The availability of the Section 199A deduction for the shareholders with respect to the corporate payment (e.g., on the receipt of rent), might offer some hope for tax savings by cutting the shareholder's tax rates by 20 percent, but to achieve that result the Section 199A limitations on high-income taxpayers must be successfully navigated.

Additional tax considerations come into play if a closely-held corporation decides to pursue the "corporate deduction" strategy to avoid double taxation by paying compensation to a shareholder-employee. Wages are taxable at the highest ordinary income tax rates and are also subject to employment taxes equal to 12.4 percent of the social security wage base and a 2.9 percent Medicare tax on all wages. These taxes are paid one-half each by the employer and employee. Wages above $200,000 earned by a single taxpayer are also subject to a .9 percent additional Medicare tax payable by the employee. Compensation and the employer's share of employment taxes are deductible by the employer. Similar rules apply to self-employed taxpayers, except they bear the full burden of the additional tax. And

[89] The 20 percent dividend rate does correlate to income levels for the pre-2018 39.6 percent rate on ordinary income. See I.R.C. § 1(j)(5)(A)(i), (B)(ii).

remember that the shareholder's tax rate on qualified dividends can be 15, 18.8 or 23.8 percent.

The point of all the detail about employment taxes is that the payment of compensation to avoid double taxation of corporate profits introduces even more "moving parts" into the calculations. Key considerations are the amount of additional employment tax incurred as a result of paying the compensation and the combined tax rates for the corporation and the shareholder. A few generalizations can be offered. If the amount of the shareholder-employee's compensation is already above the social security wage base ($132,900 in 2019), then payments of extra compensation will not be subject to the 12.4 percent tax and the payment of compensation may save some overall tax compared to paying dividends. In contrast, if the employee's compensation is subject to the 12.4 percent tax, then the total costs to the corporation and employee of paying compensation (including employment taxes) become significantly greater. Taxpayers subject to the 12.4 percent employment tax would normally pay income tax on compensation at 10, 12, 22, or 24 percent rates and dividends received by those taxpayers would be taxed at a zero or 15 percent rate. The combination of these individual income tax rates, the 12.4 percent employment tax, and the 21 percent corporate tax make it difficult to generate overall tax savings by paying compensation compared to paying corporate dividends, and it may be preferable to pay dividends.[90] In some situations, however, the scales may be tipped in favor of compensation, such as where a shareholder-employee receives tax-free fringe benefits, Social Security service credit, or tax-deferred employer contributions to a qualified retirement plan.

In conclusion, the strategies that historically have led to constructive dividend controversies are far less robust in a world with a 21 percent corporate tax rate and preferentially taxed dividends. Shareholders of closely held corporations and their advisors will likely file away the "old learning" for the future in the event either corporate tax rates are increased or dividends are once again taxed as ordinary income.

F. ANTI-AVOIDANCE LIMITATIONS ON THE DIVIDENDS RECEIVED DEDUCTION

1. IN GENERAL

Code: §§ 243(a)(1), (3), (c); 246(a)(1), (b)(1), (c); 246A; 1059(a)–(e)(1). Skim §§ 243(b)(1); 1059(e)(2), (3), (f).

Dividends received by corporate shareholders are treated more generously for tax purposes than dividends received by individuals. If corporate shareholders were taxed in full on the dividends they receive, corporate profits would be subjected to a minimum of three levels of

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90 The comparison basically is between (1) saving the corporate tax at 21 percent, versus (2) the combination of the 12.4 percent employment tax plus the income tax paid at ordinary income rates on the compensation. At the lowest ordinary income tax rates (10 and 12 percent) the results begin to look promising, but those are also the income ranges when dividends bear no tax.

taxation—once when earned, a second time when received as dividends by the corporate shareholder, and again when distributed to the ultimate noncorporate shareholder. To alleviate this multiple taxation, Section 243 generally permits corporate shareholders to deduct 50 percent of dividends received from other corporations. The deduction is increased to 65 percent if the corporate shareholder owns 20 percent or more (by vote and value) of the distributing corporation[91] and to 100 percent for certain "qualifying" dividends if the payor and recipient corporations are members of the same affiliated group.[92] As a result, a maximum of only 50 percent of dividends received by corporate shareholders are subject to tax, for a maximum effective rate of 10.5 percent.[93] The availability of this deduction has inspired tax advisors to devise techniques to take advantage of the lower effective rate on dividends received by corporate shareholders. This section examines Congressional efforts to curtail some of these abuses.

2. SPECIAL HOLDING PERIOD REQUIREMENTS

The dividends received deduction may motivate corporate shareholders to convert capital gain (taxable at the 21 percent maximum corporate rate) to tax sheltered dividend income (taxable at a maximum rate of 10.5 percent). Assume, for example, that Converter Corporation acquires 100 shares of Distributor, Inc. for $5,250 shortly before the stock goes "ex-dividend."[94] Converter holds the stock, collects a $250 dividend, includes only 50% ($125) in income, and then sells the stock for its post-dividend value of $5,000, claiming a short-term capital loss of $250 which is available to offset other capital gains normally taxable at 21 percent. Without any patrolling mechanism, this maneuver enables a corporate shareholder to convert short-term gain into 50 percent sheltered income.

An earlier version of Section 246(c) attempted to close this loophole by denying any dividends received deduction unless the stock was held for more than 15 days (90 days for certain preferred stock), but corporations concocted methods to diminish the risk of loss during this brief 15-day holding period. Congress responded by increasing the holding period in Section 246(c) to more than 45 days during the 91-day period beginning on the date which is 45 days before the stock goes ex-dividend.[95] In the case of certain preferred stock, the required holding

91 I.R.C. § 243(c).

92 I.R.C. § 243(a)(3). The term "affiliated group" is generally defined by reference to the rules governing affiliated corporations that file consolidated tax returns. I.R.C. § 243(b)(2). A simple example would be a corporate parent and an 80 percent or more subsidiary. See I.R.C. § 1504(a). A "qualifying dividend" must be paid from earnings and profits accumulated with the payor and recipient corporations are members of the same affiliated group. I.R.C. § 243(b)(1).

93 The 10.5 percent effective rate is derived by multiplying the 50 percent includible portion of the dividends by the 21 percent maximum corporate rate.

94 The "ex-dividend" date is the first date that a buyer of the stock with respect to which a dividend has been declared is not entitled to receive the dividend.

95 I.R.C. § 246(c)(1)(A). For purposes of counting the number of days, the date of disposition but not the date of acquisition is included. I.R.C. § 246(c)(3).

period is 90 days during the 181-day period beginning on the date which is 90 days before the ex-dividend date.[96] The 45 or 90-day period is tolled whenever the corporate shareholder diminishes its risk of loss with respect to the stock in any one of several specified manners.[97] As a result, a corporation is not entitled to the dividends received deduction unless it is willing to hold the stock and incur a genuine market risk for the requisite period of time.

1059

3. EXTRAORDINARY DIVIDENDS: BASIS REDUCTION

If the dividend to be received is extraordinarily large in relation to the price of the stock, a corporate shareholder may incur a minimal risk of loss even if it holds the stock for more than 45 days. This opportunity was illustrated by a dramatic example of a tax-motivated "dividend stripping" transaction described in a Congressional committee report:[98]

> Chrysler's cumulative preferred stock sells at $36 per share shortly before Chrysler is scheduled to distribute $11.69 per share of back dividends. Corporation X has a short-term capital gain of $1 million, on which it will owe tax of $460,000 [the example uses the pre-1987 46 percent corporate rate.] It buys 85,000 shares of Chrysler preferred for $3,060,000 and holds it for 91 days. When the stock goes ex-dividend, the price drops to $24.31 per share. Assume corporation X eventually sells the stock for $24.31. Corporation X has a capital loss of $11.69 per share, or $993,650, which reduces the tax on its capital gain to $2,921, or by $457,079. It receives a dividend of $993,650, of which 85 percent [now 50 percent.], or $844,603 is excluded. The tax on the rest of the dividend is $68,562. Thus, the transaction saves $457,079 of capital gain tax at a price of $68,562 of dividend tax, a net gain of $388,517. This gain is likely to exceed, by far, whatever economic consequences result from fluctuations in the market value of Chrysler preferred during the 91-day mandatory holding period.

To deter this opportunity for tax arbitrage, Congress enacted Section 1059, which provides that a corporate shareholder receiving an "extraordinary dividend" must reduce its basis in the underlying stock (but not below zero) by the amount of the nontaxed (i.e., deductible) portion of the dividend if the corporation has not held the stock for more than two years before the "dividend announcement date"—i.e., the

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96 I.R.C. § 246(c)(2).

97 I.R.C. § 246(c)(4). See Reg. § 1.246–5.

98 Joint Committee on Taxation, Tax Shelter Proposals and Other Tax-Motivated Transactions, 98th Cong., 2d Sess. 39–40 (1984).

earliest date when the distributing corporation declares, announces or agrees to the amount or payment of the dividend.[99]

To fully understand the workings of Section 1059, some definitions are in order. An "extraordinary dividend" is defined in terms of the size of the dividend in relation to the shareholder's adjusted basis in the underlying stock. A dividend is extraordinary if it equals or exceeds certain threshold percentages—five percent of the shareholder's adjusted basis in the case of most preferred stock and ten percent of the adjusted basis in the case of any other stock.[100] To prevent easy avoidance of these percentage tests, all dividends received by a shareholder with respect to any shares of stock which have ex-dividend dates within the same period of 85 consecutive days are combined and treated as one dividend.[101] Under an alternate test, a taxpayer may elect to determine the status of a dividend as extraordinary by reference to the fair market value (rather than the adjusted basis) of the stock as of the day before the ex-dividend date.[102] This election could be beneficial if the stock had appreciated substantially from the time when it was acquired by the shareholder.

The basis reduction required by Section 1059 is only for the "nontaxed portion" of an extraordinary dividend. The "nontaxed portion" is the total amount of the dividend reduced by the taxable portion—i.e., the portion of the dividend includible in gross income after application of the dividends received deduction.[103] The basis reduction occurs at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.[104] If the nontaxed portion of an extraordinary dividend exceeds the shareholder's adjusted basis in the stock, any excess is treated as gain from the sale or exchange of property in the taxable year in which the extraordinary dividend is received.[105]

The general definition of "extraordinary dividend" is broadened in a few special situations. Section 1059(e)(1) provides that any amount treated as a Section 301 distribution to a corporate shareholder shall be an extraordinary dividend, irrespective of the shareholder's holding period in the stock or the size of the distribution, if it is a distribution in redemption of stock which is: (1) part of a partial liquidation of the

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99 I.R.C. § 1059(a)(1), (d)(5). A distribution that otherwise would constitute an extraordinary dividend will not be considered as such if the shareholder has held the stock during the entire existence of the corporation or any predecessor corporation. I.R.C. § 1059(d)(6).

100 I.R.C. § 1059(c)(1), (2).

101 I.R.C. § 1059(c)(3)(A). In addition, all dividends received with respect to a share of stock which have ex-dividend dates during the same period of 365 consecutive days are treated as extraordinary if the aggregate of such dividends exceeds 20 percent of the basis in such stock. I.R.C. § 1059(c)(3)(B). These rules are extended to include dividends received with respect to shares of stock having a substituted basis. I.R.C. § 1059(c)(3)(C).

102 I.R.C. § 1059(c)(4). This option is available only if the taxpayer establishes the fair market value of the stock to the satisfaction of the Commissioner.

103 I.R.C. § 1059(b).

104 I.R.C. § 1059(d)(1).

105 I.R.C. § 1059(a)(2). This treatment avoids the tax taboo of a negative basis. Cf. I.R.C. § 357(c) and Chapter 2D, supra.

redeeming corporation[106], or (2) is non pro rata as to all shareholders.[107] In addition, a corporate shareholder will recognize immediate gain with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered if the redemption is treated as a dividend because of the holding of options that are treated as constructively owned by the shareholder under Section 318 or when Section 304(a) applies.[108] This rather obscure provision was enacted in response to a few highly publicized transactions where corporate taxpayers sought to structure sales of stock as "dividend" redemptions in order to shelter their gain through the dividends received deduction.

Two other special rules carve out liberalizing exceptions. First, certain distributions between an affiliated group of corporations that qualify for the 100 percent dividends received deduction under Section 243(b)(1) are not treated as extraordinary dividends.[109] Second, special relief is provided for "qualified preferred dividends," which are defined as dividends payable with respect to any share of stock which provides for fixed preferred dividends payable not less than annually and was not acquired with dividends in arrears.[110] A "qualified preferred dividend" is not treated as an extraordinary dividend if the dividends received by the shareholder during the period it owned the stock do not exceed an annualized rate of 15 percent of the lower of (a) the shareholder's adjusted basis or (b) the liquidation preference of the stock, and the stock is held by the shareholder for over five years.[111] The theory for this complex exception is that, unlike the typical extraordinary dividend, a qualified preferred dividend offers no potential for effectively purchasing a dividend that accrued prior to the date on which the stock was acquired.

4. DEBT-FINANCED PORTFOLIO STOCK

Corporate shareholders have also in the past exploited the dividends received deduction by borrowing funds to acquire dividend paying stock. The strategy basically has been to debt finance the purchase of stock that pays a significant dividend. The goals of the corporate shareholder have been to both (1) be able to deduct the interest paid on the debt incurred in the purchase, and (2) obtain the dividends received deduction for dividends paid on the stock. Absent the impact of taxes, the transaction normally would not make economic sense because the corporate shareholder's interest expense would be greater than the dividend

[106] "Partial liquidation" is defined for this purpose under the tests in Section 302(e). See Chapter 5D, infra.

[107] The tax consequences of stock redemptions are covered in Chapter 5, infra.

[108] I.R.C. § 1059(e)(1)(A)(iii). Section 304 is covered in Chapter 5G, infra.

[109] I.R.C. § 1059(e)(2).

[110] I.R.C. § 1059(e)(3)(C)(i).

[111] I.R.C. § 1059(e)(3)(A), (B). If all these requirements are met except for the five-year holding period, the exclusion from extraordinary dividend treatment is more limited. I.R.C. § 1059(e)(3)(A)(ii).

payout. But if the interest expense is fully deductible and only a portion of the dividend is taxable, the arrangement can possibly become a low risk arbitrage maneuver. If the net benefit of the dividend (that is lightly taxed by virtue of the dividends received deduction) exceeds the cost of the interest expense (after the corporation's deduction), the corporate shareholder will reap the after-tax profit. One of the effects of the Tax Cuts and Jobs Act's reduction in the corporate tax rate to 21 percent is to limit the efficacy of this strategy by reducing the tax benefit derived from the corporate deduction for interest expense. Nevertheless, the Code continues to guard against the abuse of debt financing dividends eligible for the dividends received deduction.

Section 246A precludes this strategy by reducing a corporation's dividends received deduction to the extent dividends are attributable to "debt-financed portfolio stock." A similar policy is reflected in Section 265(a)(2), which denies a deduction for interest incurred to purchase or carry tax-exempt municipal bonds. Thus, if "portfolio stock" is entirely debt-financed, Section 246A denies any dividends received deduction. If it is debt-financed in some lesser percentage, then that same percentage of the dividends received deduction is denied.[112] In all events, however, the reduction in the dividends received deduction may not exceed the amount of any interest deduction allocable to the dividend (i.e., to the borrowed funds directly attributable to the stock).[113]

Stock is "debt-financed" if it is "portfolio stock" that is encumbered by "portfolio indebtedness" during a "base period" prescribed in the statute.[114] "Portfolio stock" is defined as any stock of a corporation unless the corporate shareholder owns either: (1) 50 percent of the total voting power and value of the corporation or (2) at least 20 percent of the total voting power and value and five or fewer corporate shareholders own at least 50 percent of the voting power and value, excluding preferred stock.[115] "Portfolio indebtedness" means any indebtedness directly attributable to the investment in the portfolio stock.[116] This means that the stock must have been purchased with borrowed funds or that the borrowing must be directly traceable to the acquisition, such as where the stock was pledged as security for a subsequently incurred debt in a case where the corporation reasonably could have been expected to sell the stock rather than incur the indebtedness.[117]

To illustrate, assume that Leverage Corporation acquires 100 shares of publicly traded X Corp. stock for $10,000, paying $6,000 cash from corporate funds and borrowing the $4,000 balance. X Corp. pays Leverage an annual dividend of $1,000. The stock is debt-financed to the

112 I.R.C. § 246A(a), (d).

113 I.R.C. § 246A(e).

114 I.R.C. § 246A(c)(1), (d)(4).

115 I.R.C. § 246A(c)(2), (4).

116 I.R.C. § 246A(d)(3)(A).

117 H.R.Rep. No. 98–432, 98th Cong., 2d Sess. 1181 (1984).

extent of $4,000. The percentage of debt-financing is thus 40 percent (the "average portfolio indebtedness," as defined by Section 246A(d)). Under the convoluted formula in Section 246A(a), Leverage subtracts 40 percent from 100 percent and then multiplies the result (60 percent here) by the usual 50 percent dividends received deduction percentage, to reach 30 percent. That lower figure is substituted for 50 percent in determining Leverage's Section 243 deduction. When Leverage receives its $1,000 dividend, it may deduct only $300 (rather than the usual $500).

5. SECTION 301(e)

The adjustments to earnings and profits required by Sections 312(k) and 312(n) for depreciation and other timing items frequently result in an increase to a corporation's earnings and profits[118] and may cause earnings and profits to exceed the corporation's taxable income. For example, a corporation that reports a gain on the installment method may not defer the gain for purposes of determining its earnings and profits.[119] The increase in earnings and profits resulting from these adjustments often ensures that a distribution will be fully taxable as a dividend to noncorporate shareholders. Because of the dividends received deduction, this may prove to be a bonanza to a corporate shareholder. The following example from the legislative history illustrates one type of abuse that concerned Congress:[120]

> For example, assume that P Corporation owns 100 percent of the stock of X Corporation, that P's basis in such stock is $400 [Ed.], that P and X file separate income tax returns, and that X has no current or accumulated earnings and profits. Assume further that X sells an asset for a $1,000 installment note, realizing an $800 gain. Finally, assume that X borrows $500 secured by the installment note and distributes the $500 to P. Under [Section 312(n)(5)], absent a special rule, X Corporation's earnings and profits would be increased by the amount of gain on the installment sale, and P would treat the $500 distribution as a dividend. Thus P would include the $500 in income but would likely qualify for a 100-percent dividends received deduction. If P later sold its X stock for $400 [Ed.] (the value of that stock if it is assumed that X will ultimately have a $100 [Ed.] tax liability, in present value terms, on account of the installment sale), it would not recognize gain or loss on the sale. As a result, P would have realized an overall profit of $500.

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118 The purpose of these adjustments is to ensure that a corporation's earnings and profits more accurately reflect its true economic performance. See Section B of this chapter, supra.

119 I.R.C. § 312(n)(5).

120 Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (hereinafter "1984 Act General Explanation"). The example has been edited to reflect the now 21 percent corporate tax rate.

Section 301(e) prevents the result illustrated above by providing that the adjustments required by Sections 312(k) and 312(n) shall not be made for purposes of determining the taxable income of (and the adjusted basis of stock held by) any "20 percent corporate shareholder."[121] A 20 percent corporate shareholder is any corporation entitled to a dividends received deduction with respect to a distribution that owns, directly or through the Section 318 attribution rules, either (1) stock in the distributing corporation possessing at least 20 percent of the total combined voting power, or (2) at least 20 percent of the total value of all of the distributing corporation's stock, except nonvoting preferred stock.[122]

The general effect of Section 301(e) is to reduce the distributing corporation's earnings and profits in determining the tax consequences of distributions to 20 percent corporate shareholders. This reduction, in turn, may cause a distribution to be treated as a return of capital coupled with a reduction in the basis of the distributing corporation's stock. Without Section 301(e), the same distribution likely would have been a tax-free dividend with no basis reduction. Thus, applying Section 301(e) to the earlier example, X Corporation will have no earnings and profits for purposes of determining the tax consequences of a distribution to P Corporation. In the absence of earnings and profits, $400 of the distribution by X to P will be a return of capital under Section 301(c)(2), and $100 will be taxed to P as gain from the sale or exchange of its X stock under Section 301(c)(3). P's basis in its X stock will be reduced to zero and it will recognize a $400 gain on the later sale of the stock.[123]

PROBLEM

On June 1, Publicly Held Corporation's common stock is selling for $15 per share. On that date, Publicly Held declares a dividend of $1 per share, payable on June 12 to shareholders of record as of June 8. Investor Corporation purchases 1,000 shares of Publicly Held common stock for $15,000 on June 3 (two days before the June 5 ex-dividend date), collects a $1,000 dividend on June 12 and sells the stock for $14,000 on June 15.

(a) What are the tax consequences to Investor Corporation?

(b) What result in (a), above, if Investor sold the stock on December 1, instead of June 15?

(c) What result in (b), above, if Publicly Held had paid a second $1 per share dividend on August 15, and the ex-dividend date was August 5?

(d) What result in (c), above, if the August dividend is $2 per share but Investor holds the Publicly Held stock for 25 months before selling it?

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121 I.R.C. § 301(e)(1).

122 I.R.C. § 301(e)(2).

123 1984 Act General Explanation, supra note 120, at 183. The results reflect the assumed lower corporate tax rate.

TSN

CLIC

UNION MUTUAL

G. USE OF DIVIDENDS IN BOOTSTRAP SALES

TSN Liquidating Corp. v. United States

United States Court of Appeals, Fifth Circuit, 1980.
624 F.2d 1328.

■ RANDALL, CIRCUIT JUDGE:

This case presents the question whether assets distributed to a corporation by its subsidiary, immediately prior to the sale by such corporation of all the capital stock of such subsidiary, should be treated, for federal income tax purposes, as a dividend or, as the district court held, as part of the consideration received from the sale of such capital stock. We hold that on the facts of this case, the assets so distributed constituted a dividend and we reverse the judgment of the district court.

In 1969, TSN Liquidating Corporation, Inc. ("TSN"), which was then named "Texas State Network, Inc.," owned over 90% of the capital stock of Community Life Insurance Company ("CLIC"), an insurance company chartered under the laws of the State of Maine. In early 1969, negotiations began for the purchase of CLIC by Union Mutual Life Insurance Company ("Union Mutual"). On May 5, 1969, TSN and the other CLIC stockholders entered into an Agreement of Stock Purchase (the "Stock Purchase Agreement") with Union Mutual for the sale of the capital stock of CLIC to Union Mutual. The Stock Purchase Agreement provided that there would be no material adverse change in the business or assets of CLIC prior to the closing "except that as of closing certain shares and capital notes as provided in Section '4.(i).' above will not be a part of the assets of [CLIC]." Since the purchase price of the capital stock of CLIC under the Stock Purchase Agreement was based primarily on the book value (or, in some instances, market value) of those assets owned by CLIC on the closing date, the purchase price would be automatically reduced by the elimination of such shares and notes from the assets of CLIC. On May 14, 1969, as contemplated by the Stock Purchase Agreement, the Board of Directors of CLIC declared a dividend in kind, payable to stockholders of record as of May 19, 1969, consisting primarily of capital stock in small, public companies traded infrequently and in small quantities in the over-the-counter market. On May 20, 1969, the closing was held and Union Mutual purchased substantially all the outstanding capital stock of CLIC, including the shares held by TSN. The final purchase price paid by Union Mutual to the selling stockholders of CLIC was $823,822, of which TSN's share was $747,436. Union Mutual thereupon contributed to the capital of CLIC $1,120,000 in municipal bonds and purchased from CLIC additional capital stock of CLIC for $824,598 in cash paid to CLIC.

In its income tax return for the fiscal year ended July 31, 1969, TSN reported its receipt of assets from CLIC as a dividend and claimed the 85% dividends received deduction available to corporate stockholders pursuant to § 243(a)(1) of the Internal Revenue Code of 1954. TSN also reported its gain on the sale of the capital stock of CLIC on the installment method pursuant to § 453 of the Code. [Under current law, installment sale treatment would not be allowed if the CLIC stock were publicly traded. I.R.C. § 453(k)(2). Ed.] On audit, the Internal Revenue Service treated the distribution of the assets from CLIC to TSN as having been an integral part of the sale by TSN of capital stock of CLIC to Union Mutual, added its estimate ($1,677,082) of the fair market value of the assets received by TSN to the cash ($747,436) received by TSN on the sale, and disallowed the use by TSN of the installment method for reporting the gain on the sale of the capital stock of CLIC since aggregating the fair market value of the distributed assets and the cash resulted in more than 30% of the proceeds from the sale being received in the year of sale. TSN paid the additional tax due as a result of such treatment by the Internal Revenue Service, filed a claim for a refund and subsequently instituted this action against the Internal Revenue Service.

The district court made the following findings of fact in part II of its opinion:

> With regard to the negotiations between CLIC and Union Mutual in early 1969, the Court finds that Union Mutual was interested in purchasing CLIC and proposed a formula for valuing the assets, liabilities, and insurance in force, which, together with an additional amount, would be the price paid for the CLIC stock.
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> The investment portfolio of CLIC was heavily oriented toward equity investments in closely held over-the-counter securities. At least in the mind of CLIC's officers, the makeup of CLIC's investment portfolio was affecting its ability to obtain licenses in various states. As early as the Spring of 1968, the management and principal stockholders of CLIC had begun to seek a solution to the investment portfolio problem. The Court finds, however, that CLIC had never formulated a definite plan on how to solve its investment portfolio problem.
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> Union Mutual did not like CLIC's investment portfolio but considered bonds to be more in keeping with insurance industry responsibilities. The management of CLIC regarded the Union Mutual offer as a good one, and tried without success to get Union Mutual to take the entire investment portfolio.
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> Accordingly, the [Stock Purchase Agreement] required CLIC to dispose some of the investment portfolio assets. Thus, the price that would be paid for the CLIC stock was based upon a formula which valued the assets after excluding certain stocks.

* * *

> Plaintiff's disposition of the undesirable over-the-counter stock was necessitated by its sale arrangements with Union Mutual. Plaintiff had no definite plans prior to its negotiations with Union Mutual as to how to get rid of the undesirable stock, when it was to get rid of the undesirable stock, or even that it would definitely get rid of the undesirable stock. Accordingly, the Court finds that the dividend in kind of 14 May 1969 was part and parcel of the purchase agreement with Union Mutual.

TSN Liquidating Corp. v. United States, 77–2 U.S.Tax Cas. ¶ 9741 at 88,523 (N.D.Tex.1977). In part III of its opinion, the district court made the following additional findings:

> Union Mutual was interested in purchasing the stock of an approximately $2 million corporation in order that that corporation might be licensed to do business in other states. As of 30 April 1969, CLIC had assets of $2,115,138. On 14 May 1969, CLIC declared a dividend valued at approximately $1.8 million. As a result of this dividend, CLIC was left with assets totaling approximately $300,000. The final purchase price paid by Union Mutual to the selling shareholders of CLIC was $823,822. In addition, Union Mutual contributed $1,120,000 of municipal bonds to the capital of CLIC and purchased additional shares of stock of CLIC for $824,598. Thus, subsequent to closing on 20 May 1969, CLIC was worth $2,400,000. Thus, CLIC was worth $2 million when the [Stock Purchase Agreement] was signed on 5 May 1969 and worth over $2 million immediately after closing.
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> There was no business purpose served in this case by the dividend declared by CLIC prior to the sale of all its stock to Union Mutual. It is evident that the dividend benefitted the shareholders of CLIC and not CLIC itself. There was no benefit or business purpose in CLIC's declaration of the dividend separate and apart from the sale. The Court finds that the dividend would not, and could not, have been made without the sale.
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> What actually happened in the period 5 through 20 May 1969 was that the stockholders received $1.8 million in virtually tax-free stocks, as well as over $800,000 in cash, for a total of approximately $2.6 million. This was certainly a fair price for a corporation valued at the time of sale at $2,115,138, and reflects a premium paid for good will and policies in force, as well as the fact that CLIC was an existing business with licenses in eight or nine states. Hence, a $2 million corporation was sold for $2.6 million including the dividend and the cash.

After noting the time-honored principle that the incidence of taxation is to be determined by the substance of the transaction rather than by its form and the related principle that the transaction is generally to be viewed as a whole and not to be separated into its component parts, the district court held:

> The distribution of assets to [TSN] from its subsidiary, CLIC, immediately prior to [TSN's] disposition of its entire stock interest in CLIC should be treated as a part of the gain from the sale of the stock. Thus, the Court concludes that the in-kind distribution of 14 May 1969 to the stockholders of CLIC is taxable to [TSN] as gain from the sale of its stock. The alleged dividend was merely intented [sic] to be part of the purchase price paid by Union Mutual to CLIC for its stock.

The district court relied for its holding primarily on the cases of Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir.1970), cert. denied, 401 U.S. 939, 91 S.Ct. 936, 28 L.Ed.2d 219 (1971), and Basic, Inc. v. United States, 549 F.2d 740 (Ct.Cl.1977), all discussed infra.

On appeal, TSN argues that the cases relied upon by the district court are exceptions to what TSN characterizes as the established rule, namely, that assets removed from a corporation by a dividend made in contemplation of a sale of the stock of that corporation, when those assets are in good faith to be retained by the selling stockholders and not thereafter transferred to the buyer, are taxable as a dividend and not as a part of the price paid for the stock for the reason that, in economic reality and in substance, the selling stockholders did not sell and the buyer did not purchase or pay for the excluded assets. The principal cases cited by TSN for its position are Gilmore v. Commissioner, 25 T.C. 1321 (1956), Coffey v. Commissioner, 14 T.C. 1410 (1950), and Rosenbloom Finance Corp. v. Commissioner, 24 B.T.A. 763 (1931). According to TSN, the controlling distinction between the *Coffey* line of cases relied upon by TSN and the *Waterman* line of cases relied upon by the district court is whether the buyer negotiated to acquire and pay for the stock, exclusive of the assets distributed out as a dividend, on the one hand, or whether the buyer negotiated to acquire and pay for the stock, including the assets which were then the subject of a sham distribution designed to evade taxes, on the other hand. In the former case, according to TSN, there is a taxable dividend; in the latter case there is not.

We begin by noting that the district court was certainly correct in its position that the substance of the transaction controls over the form and that the transaction should be viewed as a whole, rather than being separated into its parts. Further, having reviewed the record, we are of the view that the operative facts found so carefully by the district court are entirely accurate (except for the valuation of the distributed assets, as to which we express no opinion). We differ with the district court only in the legal characterization of those facts and in the conclusion to be drawn therefrom. We agree with TSN that this case is controlled by the *Coffey, Gilmore* and *Rosenbloom* cases rather than by the *Waterman* and *Basic* cases relied upon by the district court.

In *Coffey,* the principal case relied upon by TSN, the taxpayers owned the stock of Smith Brothers Refinery Co., Inc. and were negotiating for the sale of such stock. Representatives of the purchasers and representatives of the sellers examined and discussed the various assets owned by Smith Brothers Refinery Co., Inc., and the liabilities of the company, with a view to reaching an agreement upon the fair market value of the stock. During these negotiations, the representatives of the purchasers and of the sellers could not agree upon the value of certain assets (including a contingent receivable referred to as the Cabot payment). The representatives of the purchasers informed the representatives of the sellers that the sellers could withdraw those assets from the assets of the company and that they would buy the stock without those assets being a part of the sale, thereby eliminating the necessity for arriving at a valuation of those assets in determining the value of the stock on a net worth basis. The contract of sale provided that the unwanted assets would be distributed by the corporation as a dividend prior to the sale of the stock. The selling stockholders contended before the tax court, as the Internal Revenue Service does in the case before this court, that the Cabot payment distributed to them as a dividend in kind was "part of the consideration for stock sold and that any profit resulting from its receipt by them is taxable as a capital gain." The tax court rejected that contention because it was contrary to the substance of the transaction:

> We do not agree with petitioners that they received the Cabot payment as part of the consideration for the sale of their stock. The purchasers did not agree to buy their stock and then turn over to them $190,000 and the Cabot payment in consideration therefor. From the testimony above set forth it is apparent that they were not interested in the Cabot payment, did not want it included in the assets of the corporation at the time they acquired its stock, and negotiated with petitioners to acquire stock of a corporation whose assets did not include the unwanted Cabot payment. * * * They received $190,000 for their stock. Under the contract of sale, they did not sell or part with their interest in the Cabot contract. It was expressly reserved by them and was a distribution they received as stockholders by virtue of the reservation.

Coffey, 14 T.C. at 1417, 1418. The tax court held the distribution to be a dividend. [The court then discussed two other cases reaching the same conclusion on similar facts. Ed.] * * *

The Internal Revenue Service states that it does not disagree with the holdings in *Coffey, Gilmore* and *Rosenbloom,* but it takes the position that they do not apply in the circumstances of this case. The Internal

Revenue Service focuses on the receipt by the selling stockholders of CLIC of investment assets, followed immediately by an infusion by Union Mutual of a like amount of investment assets into CLIC, and says that the reinfusion of assets brings the case before the court within the "conduit rationale" of *Waterman.* In *Waterman,* Waterman Steamship Corporation ("Waterman") was the owner of all the outstanding capital stock of Pan-Atlantic Steamship Corporation ("Pan-Atlantic") and Gulf Florida Terminal Company, Incorporated ("Gulf Florida"). Malcolm P. McLean made an offer to Waterman to purchase all the outstanding capital stock of Pan-Atlantic and Gulf Florida for $3,500,000. Since Waterman's tax basis for the stock of the subsidiaries totaled $700,000, a sale of the capital stock of the subsidiaries for $3,500,000 would have produced a taxable gain of approximately $2,800,000. Because the treasury regulations on consolidated returns provided that the dividends received from an affiliated corporation are exempt from tax, a sale of capital stock of the subsidiaries for $700,000, after a dividend payment to Waterman by the subsidiaries of $2,800,000, would, at least in theory, have produced no taxable gain. The Board of Directors of Waterman rejected McLean's offer, but authorized Waterman's president to submit a counter proposal providing for the sale of all the capital stock in the subsidiaries for $700,000, but only after the subsidiaries paid dividends to Waterman in the aggregate amount of $2,800,000. As finally consummated, the dividends and the sale of the capital stock of the subsidiaries took the following form:

(1) Pan-Atlantic gave a promissory note to Waterman for $2,800,000 payable in 30 days as a "dividend."

(2) One hour later, Waterman agreed to sell all of the capital stock of Pan-Atlantic and Gulf Florida for $700,000.

(3) Thirty minutes later, after the closing of the sale of the capital stock of the subsidiaries had occurred, Pan-Atlantic held a special meeting of its new Board of Directors, and the Board authorized Pan-Atlantic to borrow $2,800,000 from McLean and a corporation controlled by McLean. Those funds were used by Pan-Atlantic promptly to pay off the $2,800,000 note to Waterman (which was not yet due).

In its tax return for the fiscal year involved, Waterman eliminated from income the $2,800,000 received as a dividend from Pan-Atlantic and reported $700,000 as the sales price of the capital stock of the two subsidiaries. Since Waterman's tax basis for the stock was the same as the sales price therefor, no taxable gain was realized on the sale. On audit, the Internal Revenue Service took the position that Waterman had realized a long-term capital gain of $2,800,000 on the sale of the capital stock of the subsidiaries and increased its taxable income accordingly. On appeal from a judgment by the tax court in favor of the taxpayer, the Internal Revenue Service contended that the rules applicable to situations where a regular dividend has been declared are not applicable when the parties contemplate that a purported dividend is to be inextricably tied to the purchase price and where, as was the case before the court, the amount of the dividend is not a true distribution of corporate profits. The Internal Revenue Service argued that the funds were supplied by the buyer of the stock, with the corporation acting as a mere conduit for passing the payment through to the seller. This court agreed with the Internal Revenue Service:

> The so-called dividend and sale were one transaction. The note was but one transitory step in a total, pre-arranged plan to sell the stock. We hold that in substance Pan-Atlantic neither declared nor paid a dividend to Waterman, but rather acted as a mere conduit for the payment of the purchase price to Waterman.

Waterman, 430 F.2d at 1192. The opinion of this court began with this sentence:

> This case involves another attempt by a taxpayer to ward off tax blows with paper armor.

Id. at 1185. The opinion stressed the sham, tax motivated aspects of the transaction:

> Here, McLean originally offered Waterman $3,500,000 for the stock of Pan-Atlantic and Gulf Florida. Waterman recognized that since its basis for tax purposes in the stock was $700,180, a taxable gain of approximately $2,800,000 would result from the sale. It declined the original offer and proposed to cast the sale of the stock in a two step transaction. Waterman proposed to McLean that it would sell the stock of the two subsidiaries for $700,180 after it had extracted $2,800,000 of the subsidiaries' earnings and profits. It is undisputed that Waterman intended to sell the two subsidiaries for the original offering price—with $2,800,000 of the amount disguised as a dividend which would be eliminated from income under Section 1502. Waterman also intended that none of the assets owned by the subsidiaries would be removed prior to the sale. Although the distribution was cast in the form of a dividend, the distribution was to be financed by McLean with payment being made to Waterman through Pan-Atlantic. To inject substance into the form of the transaction, Pan-Atlantic issued its note to Waterman before the closing agreement was signed. The creation of a valid indebtedness however, cannot change the true nature of the transaction. * * *
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> The form of the transaction used by the parties is relatively unimportant, for the true substance and effect of their agreement was that McLean would pay $3,500,000 for all of the

> assets, rights and liabilities represented by the stock of Pan-Atlantic and Gulf Florida.

Id. at 1194–95. This court concluded its opinion in *Waterman* by cautioning against "giving force to 'a purported [dividend] which gives off an unmistakably hollow sound when it is tapped.'" Id. at 1196 (quoting United States v. General Geophysical Co., 296 F.2d 86, 89 (5th Cir.1961), cert. denied, 369 U.S. 849, 82 S.Ct. 932, 8 L.Ed.2d 8 (1962)). A final footnote to the opinion stated that the decision should not be interpreted as standing for the proposition that a corporation which is contemplating a sale of its subsidiary's stock could not under any circumstances distribute its subsidiaries' profits prior to the sale without having such distribution deemed part of the purchase price. Id. at 1196 n. 21.

In summary, in *Waterman,* the substance of the transaction, and the way in which it was originally negotiated, was that the purchaser would pay $3,500,000 of its money to the seller in exchange for all the stock of the two subsidiaries and none of the assets of those subsidiaries was to be removed and retained by the sellers. In the case before the court, the district court found that Union Mutual did not want and would not pay for the assets of CLIC which were distributed to TSN and the other stockholders of CLIC. Those assets were retained by the selling stockholders. The fact that bonds and cash were reinfused into CLIC after the closing, in lieu of the unwanted capital stock of small, publicly held corporations, does not convert this case from a *Coffey* situation, in which admittedly unwanted assets were distributed by the corporation to its stockholders and retained by them, into a *Waterman* situation, in which the distribution of assets was clearly a sham, designed solely to achieve a tax free distribution of assets ultimately funded by the purchaser. Indeed, the Internal Revenue Service does not argue, in the case before the court, that the transaction was in any respect a sham. Instead, the Service would have us hold that the mere infusion of assets into the acquired company after the closing, assets which are markedly different in kind from the assets that were distributed prior to the closing, should result in the disallowance of dividend treatment for the distribution of the unwanted assets, and the Service cites *Waterman* as authority for that proposition. We view the sham aspect—the hollow sound—of the transaction described in *Waterman* as one of the critical aspects of that decision, and we decline to extend the *Waterman* rule to a case which admittedly does not involve a sham and which, in other important respects, is factually different from *Waterman*.

The Internal Revenue Service also cites *Basic* as authority for the disallowance of dividend treatment for the distribution of the unwanted assets in this case. * * * [The court distinguished the Court of Claims decision in *Basic* on the ground that the asset distributed as a pre-sale dividend in *Basic* was promptly transferred to the buyer while in this case the distributed assets were retained by the target corporation's shareholders. Ed.]

As additional support for its position, the court in *Basic* focused on the absence of a business purpose, viewed from the standpoint of Falls, for the payment of a dividend of a valuable corporate asset, i.e., the capital stock of Carbon, by Falls to Basic. The district court, in the case before this court, applied the same test to the payment of the dividend of the unwanted assets by CLIC to TSN, the controlling stockholder of CLIC, and found that, strictly from the standpoint of CLIC, the dividend was lacking in business purpose and, indeed, could not have taken place apart from the sale and the subsequent infusion of investment assets into CLIC by Union Mutual. However, it seems to us to be inconsistent to take the position that substance must control over form and that a transaction must be viewed as a whole, rather than in parts, and at the same time to state that the business purpose of one participant in a multi-party transaction (particularly where the participant is a corporation controlled by the taxpayer and is not itself a party to the sale transaction) is to be viewed in isolation from the over-all business purpose for the entire transaction. We agree that the transaction must be viewed as a whole and we accept the district court's finding of fact that the dividend of the unwanted assets was "part and parcel of the purchase arrangement with Union Mutual," motivated specifically by Union Mutual's unwillingness to take and pay for such assets. That being the case, we decline to focus on the business purpose of one participant in the transaction—a corporation controlled by the taxpayer—and instead find that the business purpose for the transaction as a whole, viewed from the standpoint of the taxpayer, controls. The facts found by the district court clearly demonstrate a business purpose for the presale dividend of the unwanted assets which fully explains that dividend. We note that there is no suggestion in the district court's opinion of any tax avoidance motivation on the part of the taxpayer TSN. The fact that the dividend may have had incidental tax benefit to the taxpayer, without more, does not necessitate the disallowance of dividend treatment.

Having concluded that the pre-sale distribution by CLIC to its stockholders (including TSN) of assets which Union Mutual did not want, would not pay for and did not ultimately receive is a dividend for tax purposes, and not part of the purchase price of the capital stock of CLIC, we reverse the judgment of the district court and remand for proceedings consistent with this opinion.

Reversed and remanded.

NOTE

Life is not as simple today as it was when the successful tax plan in *TSN Liquidating* was concocted. Several additional provisions of the Code now must be considered in evaluating the continuing viability of a pre-sale distribution of unwanted assets by a corporate shareholder.

As noted earlier,[124] Section 301(e) requires, solely for purposes of computing the amount of any taxable dividend income to a 20 percent or more corporate shareholder and the shareholder's basis in the stock of the distributing corporation, that the distributing corporation's earnings and profits must be determined without regard to the special adjustments in Sections 312(k) and 312(n). Section 301(e), however, will not necessarily impair the technique used in *TSN Liquidating*; it merely limits the utility of pre-acquisition dividend strips to situations where the distributing corporation has substantial earnings and profits before the required earnings and profits timing adjustments.

A more serious impediment is the possibility of a downward adjustment in the basis of the corporate shareholder's stock as a result of the pre-sale dividend. If TSN had been required to reduce the basis in its CLIC stock by the amount of the dividends received deduction that it was allowed on the distribution, the transaction would have lost its allure. A basis reduction would have placed TSN in the position of trading a dollar of dividend income for a dollar of gain on the subsequent sale of its CLIC stock. Since corporations do not enjoy a capital gains preference, they usually are indifferent to the distinction between ordinary income and capital gain.[125] Does current law cause TSN to suffer a basis reduction as a result of the pre-sale dividend? The answer is no unless the distribution is subject to Section 1059. That section requires a basis reduction for the amount of any "extraordinary dividend" which was not taxed to a corporate shareholder because of the dividends received deduction where the stock has not been held for more than two years before the announcement of the dividend.[126] Because of its size (roughly $1.67 million, according to the facts of the case), the dividend to TSN appears to be "extraordinary" under the tests in Section 1059(c). But TSN nonetheless could have avoided any basis reduction if it had held its CLIC stock for more than two years before the dividend was announced.

One final obstacle must be mentioned in the interests of full disclosure. If TSN and CLIC were affiliated corporations and elected to file a consolidated tax return,[127] TSN would have been required to reduce its basis in the CLIC stock as a result of the dividend. The consolidated return regulations, which treat an "affiliated group" as a single taxpaying entity, logically eliminate intracorporate dividends from the consolidated group's joint gross income.[128] The dividend is considered a mere reshuffling of profits within a single taxpayer which should not generate additional income. The regulations also provide that a parent's basis in the stock of a subsidiary is generally reduced by the full amount of any excluded intercompany

[124] See Section F5 of this chapter, supra.

[125] Other tax attributes, however, might cause TSN to prefer one or the other type of income. For example, if TSN had unused capital losses, it might prefer capital gains on the sale to fully taxable dividend income.

[126] I.R.C. § 1059(a). See Section F3 of this chapter, supra.

[127] See Chapter 13, supra.

[128] Reg. § 1.1502–13(f)(2)(ii).

dividend.[129] It follows that the strategy employed in *TSN Liquidating* has no appeal in the context of a consolidated group.

Despite these technical hurdles, a pre-sale dividend is still viable if the selling parent corporation has held the stock of a subsidiary for more than two years and the corporations do not file a consolidated return. The Tax Court's decision in Litton Industries, Inc. v. Commissioner[130] illustrates the importance of form and timing to the success of this technique. The issue in *Litton* was whether a $30 million dividend, paid to Litton by a wholly owned subsidiary in the form of a negotiable promissory note five months prior to Litton's sale of the subsidiary's stock to Nestle Corporation, was truly a dividend rather than part of the proceeds received by Litton on the sale of the stock. The promissory note was later satisfied by Nestle at the same time that it purchased the stock. Dividend treatment was preferable to Litton because of the shelter provided by what was then an 85 percent dividends received deduction.

Distinguishing Waterman Steamship Corp. v. Commissioner[131] (discussed in *TSN Liquidating* at pages 193–195 of the text, supra), the Tax Court held that the payment was a dividend. Favorable (and distinguishing) factors were: (1) unlike *Waterman Steamship,* the dividend and subsequent sale in *Litton* were substantially separated in time (over five months in *Litton* was better than the few hours in *Waterman*); (2) at the time the dividend was declared, no formal action had been taken by the parent to initiate a sale to Nestle and "[t]here was no definite purchaser waiting in the wings with the terms and conditions of sale already agreed upon;"[132] and (3) as in *TSN Liquidating,* the overall transaction was not a sham because a business purpose was served by the dividend. In rejecting the Service's contention that the dividend and subsequent sale of the subsidiary should be treated as one transaction for tax purposes, the court reasoned:[133]

> The term "dividend" is defined in section 316(a) as a distribution by a corporation to its shareholders out of earnings and profits. The parties have stipulated that Stouffer had earnings and profits exceeding $30 million at the time the dividend was declared. This Court has recognized that a dividend may be paid by a note. T.R. Miller Mill Co. v. Commissioner, 37 B.T.A. 43, 49 (1938), affd. 102 F.2d 599 (5th Cir.1939). Based on these criteria, the $30 million distribution by Stouffer would clearly constitute a dividend if the sale of Stouffer had not occurred. We are not persuaded that the subsequent sale of Stouffer to Nestle changes that result merely because it was more advantageous to Litton from a tax perspective.
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> It is well established that a taxpayer is entitled to structure his affairs and transactions in order to minimize his taxes. This proposition does not give a taxpayer carte blanche to set up a

129 Reg. § 1.1502–32(b)(2), (3)(v).

130 89 T.C. 1086 (1987).

131 430 F.2d 1185 (5th Cir.1970).

132 89 T.C. at 1099.

133 Id. at 1099–1100.

transaction in any form which will avoid tax consequences, regardless of whether the transaction has substance. Gregory v. Helvering, 293 U.S. 465 (1935). A variety of factors present here preclude a finding of sham or subterfuge. Although the record in this case clearly shows that Litton intended at the time the dividend was declared to sell Stouffer, no formal action had been taken and no announcement had been made. There was no definite purchaser waiting in the wings with the terms and conditions of sale already agreed upon. At that time, Litton had not even decided upon the form of sale of Stouffer. Nothing in the record here suggests that there was any prearranged sale agreement, formal or informal, at the time the dividend was declared.

Petitioner further supports its argument that the transaction was not a sham by pointing out Litton's legitimate business purposes in declaring the dividend. Although the code and case law do not require a dividend to have a business purpose, it is a factor to be considered in determining whether the overall transaction was a sham. T.S.N. Liquidating Corp. v. United States, 624 F.2d 1328 (5th Cir.1980). Petitioner argues that the distribution allowed Litton to maximize the gross after-tax amount it could receive from its investment in Stouffer. From the viewpoint of a private purchaser of Stouffer, it is difficult to see how the declaration of a dividend would improve the value of the stock since creating a liability in the form of a promissory note for $30 million would reduce the value of Stouffer by approximately that amount. However, since Litton was considering disposing of all or part of Stouffer through a public or private offering, the payment of a dividend by a promissory note prior to any sale had two advantages. First, Litton hoped to avoid materially diminishing the market value of the Stouffer stock. At that time, one of the factors considered in valuing a stock, and in determining the market value of a stock was the "multiple of earnings" criterion. Payment of the dividend by issuance of a promissory note would not substantially alter Stouffer's earnings. Since many investors were relatively unsophisticated, Litton may have been quite right that it could increase its investment in Stouffer by at least some portion of the $30 million dividend. Second, by declaring a dividend and paying it by a promissory note prior to an anticipated public offering, Litton could avoid sharing the earnings with future additional shareholders while not diminishing to the full extent of the pro rata dividend, the amount received for the stock. Whether Litton could have come out ahead after Stouffer paid the promissory note is at this point merely speculation about a public offering which never occurred. The point, however, is that Litton hoped to achieve some business purpose, and not just tax benefits, in structuring the transaction as it did.

Under these facts, where the dividend was declared 6 months prior to the sale of Stouffer, where the sale was not prearranged, and since Stouffer had earnings and profits exceeding $30 million at the time the dividend was declared, we cannot conclude that the distribution was merely a device designed to give the appearance of a dividend to a part of the sales proceeds. In this case, the form and substance of the transaction coincide; it was not a transaction entered into solely for tax reasons, and it should be recognized as structured by petitioner.

PROBLEM

Strap Corporation is the sole shareholder of X, Inc. Strap and X do not file a consolidated return, and Strap has held its X stock for more than two years. Strap has a $150,000 basis in its X stock. Boot is a prospective buyer and is willing to purchase all of the X stock, but he is unable to pay the $500,000 price demanded by Strap even though he believes it to be fair. X has $100,000 cash on hand and an ample supply of earnings and profits. To solve these problems, the parties have agreed on the following plan: Strap Corporation will cause X, Inc. to distribute $100,000 to it as a dividend. Promptly thereafter, Strap will sell its X stock to Boot for $400,000. What are the tax consequences of this plan? What if Strap were an individual rather than a corporation?