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Management of the Corporation - Distribution of Cash, Property, or Stock

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MANAGEMENT OF THE CORPORATION – DISTRIBUTIONS OF CASH, PROPERTY, OR STOCK

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The corporation discussed above has conducted business for several years and has accumulated money and appreciable assets. At this point in time, the tax advisor must be concerned with the tax consequences of all possible distributions to the corporation's shareholders. The applicable rules are found primarily in Code sections 301 through 318, although later sections dealing with partial liquidations and spinoffs are also relevant. Recent amendments to these sections, such as the substantial revision of section 305 dealing with stock dividends and new sections 311(b) and 312(m), are of equal importance and should be noted. New section 385, dealing with the difference between debt and equity, might also be quite important because in considering a transaction "with respect to stock", an early resolution of whether a particular instrument is stock or debt, must be made before distribution questions can be answered. Finally, in the recent decision of *United States v. Davis,* the Supreme Court has spoken definitively on the question of dividend equivalence under section 302(b)(1).

This paper will not consider distributions by publicly held corporations, and the subject matter encompassed by closely held corporation distributions is so great that complete treatment of that subject is not possible. The reason for this volume is that most of the rules in this area of the Code were designed for closely held corporations, to prevent what Congress came to regard as certain abuses of the tax laws by such corporations where the opportunities for manipulation, in the government's view, were most apparent. The general principles, if there are any in this area, are to try to determine what dividends are and how they are taxed, and then to consider certain other transactions which, although not constituting dividends under the corporate law of a particular state, are taxed as dividends if they meet certain requirements. If they do not meet these requirements, such transactions are taxed differently.

Under the tax law, a taxpayer in a particular situation might want to achieve an opposite result from that generally desired. The simplest example is in the area of dividend taxation. Ordinarily, dividends are fully taxable as ordinary income, the least desirable result. Thus, individual shareholders' cases usually involve the contention that the payment received was not a dividend. On the other hand, corporate shareholders receive an 85 percent dividends-received deduction in most circumstances. Thus, such shareholders frequently argue that a certain payment is a dividend, while the Commissioner takes an opposite view. For purposes of this paper, however, the assumption will be made that nondividend treatment is desirable.

CASH DISTRIBUTIONS

The words "cash distribution" are used advisedly because section 301, which begins this area of the Code, deals with distributions of property,

"property" being defined in section 317(a) as almost any type except the corporation's own stock and stock rights. A "distribution" under section 301 is a broad category encompassing not only dividends but also some non-dividend distributions. Section 301(a) states that distributions of cash, with respect to stock shall be treated as provided in section 301(c). Section 301(c)(1), as well as section 61(a)(7), provides that the amount of a distribution which is a "dividend" shall be included in gross income.

DUEL FUND CONCEPT

Section 316 defines "dividend". A significant aspect of the definition is the dual fund concept. Under section 316, a dividend can be a distribution either out of earnings and profits accumulated since February 28, 1913, or taxable year earnings and profits computed as of that year's end; the date, of course, refers to the enactment of the first income tax. For the great bulk of corporations this limitation is not terribly significant, as the two funds basically are the accumulated earnings and profits of the current year.

The Code creates certain presumptions which are applicable when identifying these two funds. The first is that every distribution a corporation makes to its shareholders comes out of earnings and profits rather than any other fund. In other words, if there are earnings and profits, a corporation cannot earmark a distribution as coming from any other source. Secondly, there is a statutory LIFO presumption, in the sense that the most recently earned earnings and profits are deemed distributed first. The consequences of this two-fund theory for dividends are several. First, there can be a taxable dividend despite an overall deficit from the inception of the corporation, so long as earnings and profits are acquired in the year of distribution. Second, the character of a distribution early in the year may change during the year. For example, a corporation with an accumulated deficit may make a distribution in June while still losing money. This would appear to be a return of capital type payment. If the year turns around, however, and a current earnings and profits fund comes into existence, that earlier distribution, irrespective of its former apparent character, will carry dividend attributes. Finally, a corporation with an accumulated deficit may defer a distribution to a subsequent year, a previous year dividend situation thus being turned into a tax-free distribution. Under the general heading of "Management of the Corporation," there is a considerable opportunity for real management and tax planning to minimize taxation of distributions to the shareholders.

The regulations contain additional rules which are worth noting. First, they provide that current earnings and profits are allocated pro rata to annual distributions, whereas the accumulated earnings fund is deemed to be paid chronologically throughout the year. Second, the regulations provide that a deficit is prorated throughout the year. The results of these presumptions can be quite important where shareholding changes during the course of the year. If the presumptions went the other way and there was room to argue, the tax consequences to the recipients would vary. Third, preferred stock dividends are deemed to carry earnings and profits with them in preference to dividends on common stock if both are made with only a limited amount of earnings and profits to allocate. Finally, dividends use earnings and profits in priority over redemptions.

EARNING AND PROFITS

Another important aspect of dividend identification, in addition to the dual fund concept, is the concept of earnings and profits. As initially stated, the distribution must be "out of" earnings and profits to be a dividend. Although earnings and profits are not equivalent to retained earnings, earned surplus on the corporate books, or taxable income, they can be calculated by starting with either of these funds and making adjustments. The important thing to note, however, is that they are unique. Section 312 deals with earnings and profits, but only contains a few of the rules that are necessary to make this computation. Thus, since the regulations are also of only minimal assistance, the law of earnings and profits is left to common law drawn from articles written and cases decided over the years.

The approach of both the Code and regulations is to determine a corporation's earnings and profits by starting with taxable income and then making certain subsequent adjustments. The following is a brief overview of this process. First, assume that the corporation's taxable income for the year is known. There are some items of income which increase earnings and profits, but not taxable income. Essentially, this real income is received by the corporation tax-free. Such an item is municipal bond interest. This is obviously a true source of income which, although excluded from taxable income, increases the corporation's earnings and profits. Life insurance proceeds provide a second example. Gains which are not recognized by the corporation because of Code reorganization or other tax-free exchange provisions, however, do not add to earnings and profits.

Other items which must be added back to taxable income in arriving at earnings and profits are certain special tax deductions; for example, the 85 percent dividends-received deduction, the net operating loss deduction, capital loss carryovers, the excess of percentage depletion over cost depletion, and, by virtue of new section 312(m), the excess of accelerated depreciation over straight line depreciation. In other words, some of the tax incentive must be reversed, at least for purposes of computing earnings and profits. The excess depreciation item was put in the Code to prevent many large public utility corporations which use depreciation deductions from paying out wholly or partially tax-free dividends, as they have done for many years.

Taxable income, having been increased by some items, must now be reduced by others to arrive at earnings and profits. The first reduction item is a type of special tax income which is not really income. An example is the gross-up dividend under section 78 involving the section 902 foreign tax credit. A second, and more important area, concerns reductions related to such items as nondeductible life insurance premiums and expenses to earn exempt income. The two most important items in this category are dividends previously paid out and federal income tax payments.

Another situation now arises: suppose there is a distribution which is in excess of earnings and profits. Such a distribution is not a dividend. Section 301(c)(2) states that the first thing to be done with any such excess distribution is to reduce the stock basis, thus making the distribution tax-free. Once such basis has been reduced to zero, section 301(c)(3) provides that any further distributions are treated as payments in exchange for stock which, in the ordinary case, would give rise to capital gain treatment for the stockholder.

CONSTRUCTIVE RECEIPT

The next area involves transactions which, although clearly not dividends in form, because of the form of enterprise, such as the closely held family corporation or incorporated partnership type of business, are considered to be dividends constructively received. For example, if two commonly controlled corporations have dealings with each other from which one clearly derives a benefit, the Service will frequently take the position that the true nature of the transaction is that one corporation paid a dividend to its shareholders who received that benefit in property or cash and then retransferred it to the other corporation. Another example is loans to shareholders by closely held corporations where it appears from all the facts and circumstances that there is no intent to repay. If a corporation pays its shareholders' obligations, such payment will ordinarily be treated as a dividend. Where a corporate payment benefits a shareholder and also the corporation, the Internal Revenue Service again seeks dividend treatment. Bargain purchases, interest-free loans, rent-free use of corporate property, and excessive compensation all may be considered constructive dividends to the shareholder.

This area presents a few other interesting problems. One is the tax consequences of an assignment of dividend income – either by an assignment of the right to receive the dividend or by an assignment of stock after a dividend has been declared. Another difficult question is whether a waiver of dividends by the controlling shareholder of a closely held corporation is covered by Revenue Procedure 67-14. Finally, there is the area of bootstrap sales, which has been the subject of some important litigation within the past year or two. In one case, corporate shareholders caused dividends to be paid up prior to the sale of a subsidiary corporation, because the receipt of the dividend was more advantageous at that time than if the payment had come from the purchaser of the subsidiary. The court held that the dividend payments should be taxed as if they were part of the sales price of the company.

PROPERTY DISTRIBUTIONS

Although the distribution of property adds further complication to the dividend area, most of the rules stated above apply. There are, however, important exceptions. It should first be noted that, under certain circumstances, the corporation making the distribution of property may be deemed to realize income, if the property's value, at the time of the distribution, exceeds its basis. This applies if there is a LIFO inventory distribution, a liability attached to property in excess of its basis, an application of section 1245 or 1250 recapture to a sale, and so on. These are, however, very specific exceptions. The general rule is that if there is a dividend payment as distinguished from a stock redemption, the corporation itself does not realize income upon the distribution of appreciated property. With regard to individual recipients of dividends of property, such as real estate and stock in other corporations, the rule is that the recipient is taxed at the market value of the property to the extent of earnings and profits.

One of the most intriguing questions in this area arose under the 1939 Code in the situation where the basis of property distributed was less than but the value more than earnings and profits. How should the shareholder be taxed? It was held that, in this circumstance, the shareholder should be taxed on the full fair market value of the property or that the earnings and profits, in effect, would be automatically increased to cover the distribution. The 1954 Code does not speak to this, but the regulations favor the taxpayer—the earnings and profits at the time of the distribution are the measure of dividend income. An individual shareholder's basis in the property he receives is, of course, the fair market value of the property.

The foregoing rules change if there is a corporate recipient of a property dividend. A corporate shareholder's taxable income is the lesser of the distributing corporation's adjusted basis in the property or its fair market value. This provision prevents the corporate shareholder from obtaining a step-up in basis of depreciable property with only a tax on 15 percent of the distribution because of the 85 percent dividends-received deduction. This variation in the treatment of individual and corporate shareholders may present some interesting planning opportunities. The individual shareholder does not care whether he receives high or low basis property – the corporate shareholder may care very much. These planning opportunities may be frustrated, however, by the Service's use of such theories as constructive exchange.

The effect on earnings and profits of a property dividend distribution is that they are reduced by the basis of the distributed property. Thus, if the fair market value of the property exceeds its basis, the dividend to an individual shareholder is greater than the reduction in earnings and profits. This will leave some earnings and profits for the following year. On the other hand, if a dividend of high-basis property is distributed, earnings and profits may be reduced to zero, perhaps permitting a tax-free distribution the next year. There are exceptions to this rule. For example, there may be a situation where the corporation does not realize income, but nevertheless, earnings and profits increase. Such exceptions include distributions of inventory, receivables relating to the sale of inventory, and certain installment obligations.

A corporation, of course, can distribute its own obligations. It can create a note, or series of notes, saying that it owes the shareholders money and distribute those securities as dividends. The statute provides no special rule for such a situation. An intriguing question is presented in the case of a corporate shareholder, which ordinarily measures the amount of its dividends by the distributing corporation's basis. The distributing corporation has no basis in its own obligations, but the regulations state that a corporate distributee takes the obligations at their fair market value. Intriguingly enough, section 312(a)(2) provides that earnings and profits are not reduced by such fair market value, but rather by the principal amount of the corporate obligations.

Stock Distribution

Section 305 deals with distribution of stock and stock rights. In contrast to the past, this area is now very complicated. Regulations passed in 1968 and Code amendments in 1969 which superseded them were an attempt by the Service and Congress to attack some of the very complicated securities promulgated by conglomerates in their acquisitions. The result was a statute which might affect, very significantly, any closely held corporation other than one with the simplest stock structure.

The general thrust of section 305(a) is that a distribution of stock or stock rights, with respect to stock, is tax-free. In practice, after 1969, this probably means that only dividends of common on common or preferred pro rata on common, when there are no other classes of securities, now will be tax-free. Section 305(b) contains exceptions to this basic rule of nontaxability. The first exception is where the shareholder can *elect* to take cash or stock. The election provides cash dividend tax treatment for the stock dividend.

A second exception is the disproportionate distribution. In that situation the distribution of stock results in the receipt of property by some shareholders and an increased interest in earnings or assets by other shareholders. The shareholders realizing this increased interest, whether through, *inter alia,* a stock dividend, a redemption of other shares, or a change in conversion ratios, will be treated as if they had received a dividend of property. For example, the regulations provide that the mere existence of two classes of common stock is sufficient to produce taxation of the stock dividend in situations where one class of stock gets so many dollars worth of stock as a stock dividend and the other gets cash in the same amount.

Under the third exception, if there is a stock dividend where some shareholders receive common and others preferred, both are taxable. Any distribution of stock with respect to preferred stock is taxable. Finally, any distribution of convertible preferred stock is a taxable dividend. Section 305(c) lists several other events which might be considered stock dividends. Now out in proposed form, regulations required by this section describe whether such events are to be treated as constructive stock dividends.

STOCK REDEMPTION

Section 301(a) begins with the words "except as otherwise provided." The stock redemption, as distinguished from dividends or distributions, is the most important exception to the rules of section 301, particularly in the closely held corporation.

The problem is that the closely held corporation has accumulated funds and proposes to redeem some of its stock. From the shareholder's point of view, the basic issue is whether this transaction should be treated as a sale of stock or as a section 301 distribution. At the extremes, the decision is quite easy. If a sole shareholder owns nothing but common stock and, at a time when his corporation has earnings and profits, he receives a cash distribution in return for stock certificates, the distinction between the alleged redemption and a distribution of an ordinary dividend is so slight that most would agree he received a dividend and should be taxed accordingly. At the other extreme is the shareholder who sells all of his stock back to the company and has no further connection with it. Clearly he should be taxed as if he sold the stock to a complete stranger. Between these extremes, however, the problems are considerably more difficult. The essence of the issue is whether the distribution is pro rata or whether it has the net effect of a dividend in terms of the recipient's situation before and after the redemption transaction.

Another type of distribution in exchange for stock – the partial liquidation – looks at matters from the corporate point of view. This will be discussed later. For present purposes, therefore, it is assumed that, whatever the cause of redemption, it does not qualify as a partial liquidation. Section 302(a) states the basic rule for redemption transactions. It provides that a stock redemption, as defined in section 317(b), will be treated as a payment in exchange for the shareholder's stock if paragraph (1), (2), (3), or (4) of section 302(b) applies. Thus, it appears that a redemption generally will be treated as an exchange. However, for such treatment, the transaction must fit within one of the four enumerated categories. If it fails to do so, section 302(d) gives it section 301 treatment. Section 302(b), as indicated, lists the requirements for exchange treatment, and section 302(c) makes reference to attribution rules, to be discussed below.

Section 302(b)(2), (3), and (4) frequently are referred to as "safe harbors." That is, if a transaction can be found applicable to one of these paragraphs, it will qualify for exchange treatment–ordinarily, capital gain treatment. Section 302(b)(4) is a very esoteric section dealing with railroad reorganizations, and thus is of limited application. Sections 302(b)(2) and (3) were enacted in response to requests for certainty in order to aid in planning and to enable a tax advisor to assure a client that his transaction will be treated as an exchange rather than as a dividend.

Section 302(b)(3) is entitled "Complete Termination of a Shareholder's Interest." If *all* of a shareholder's stock is redeemed, the transaction is equivalent to a sale and will be treated as such. Complicating such a transaction are the attribution rules contained in section 318. They frequently come into play in the context of the closely held or family corporation. Under these rules, even though all the shares of a family corporation actually owned by a father are surrendered, he nevertheless will be considered the constructive owner of other shares. Thus, he will not have achieved a complete termination of interest and his redemption will not qualify as a complete termination under section 302(b)(3). An important exception to the attribution rules in this area will be discussed shortly. Another tenuous situation is a purported complete termination with the shareholder receiving a debt instrument and either pledged stock or an unreasonably long maturity date. Finally, if there is a simultaneous sale of some stock and a redemption of the balance, such redemption will qualify as a complete termination.

Obviously, the clearest example of a non pro rata redemption is a complete termination. However, such a redemption is not necessary to achieve tax certainty. A "substantially disproportionate" redemption is sufficient to produce exchange treatment. Section 302(b)(2) defines "substantially disproportionate". The requirements are as follows:

1. The shareholder must own less than 50 percent of the voting power of the corporation.
2. The shareholder's percentage of voting stock immediately after the redemption must be less than 80 percent of his percentage of voting stock immediately prior to the redemption.
3. His percentage of common stock immediately after the redemption must be less than 80 percent of his percentage of common stock immediately prior to the redemption.

Of course, problems may arise in defining "voting stock". For example, preferred stock, which votes only on default, is not considered voting stock. Problems may also arise in defining "common stock" and "voting power".

A redemption of nonvoting stock, whether preferred or common, cannot qualify under section 302(b)(2). Similarly, a redemption of preferred stock, whether voting or nonvoting, does not qualify. In planning one of these transactions, it must be remembered that both the denominator and the numerator are reduced. Thus, if a client owns forty of one hundred shares and redeems eight, he then owns thirty-two of ninety-two, more than 32 percent (*i.e.*, 80 percent of 40 percent), and has not met the percentage required under section 302(b)(2). Finally, section 302(b)(2)(D) provides that if a redemption is part of a plan for a series of redemptions, the test for substantial disproportionality is applied at the end of the series rather than at each stage.

ATTRIBUTION RULES

Section 318 contains the attribution rules discussed above. The first area deals with "family" attribution. Section 318(a)(1) provides that, irrespective of the degree of harmony between father, son, or wife, they become constructive owners of each other's stock for purposes of calculation under sections 302, 304, 306 and some of the other important provisions of the Code. The family attribution rule is that an individual is considered to own the stock of his spouse, children, grandchildren and parents. There is no reattribution – an individual's brother's stock would be attributed to his father, but not reattributed to himself.

"Direct" attribution describes the next area, where it is provided that partners are deemed to own proportionally stock owned by their partnership, beneficiaries are deemed to own stock owned by estates and trusts (an exception is the "grantor's trust", in which the grantor is deemed the owner), and corporate shareholders are deemed to own proportionally what the corporation owns. This latter provision is qualified in that the rule only applies if a shareholder, after application of the other attribution rules, is deemed to own more than 50 percent of the value of the corporation. Reattribution applies in this area – direct attribution and family attribution are combined. For example, if an individual is deemed to own stock that his wholly owned corporation owns, his son, in turn, is deemed to own that very same stock.

The third general area of attribution, so-called "back" attribution, is the converse of "direct" attribution; individual ownership is attributed to an entity. Partners' ownership is attributed to partnerships, beneficiaries' to estates and trusts, and shareholders' to corporations. In the latter situation, as in "direct" attribution, there is attribution from shareholders to corporations only where the shareholder is deemed to own 50 percent or more of the corporation's stock.

The fourth type of attribution is "option" attribution, which takes priority over the others. For example, if an individual's father had an option on another son's stock, such individual would constructively own it by a single step of family attribution.

In seeking a complete termination of interests under 302(b)(3), it is possible to waive the family attribution rules. For example, assume that an individual and his father are the only shareholders of a corporation and the father is ready to retire. If all of his stock is redeemed, it is possible for the father to agree to have no further interest in the corporation other than as a creditor and to notify the Service if he reacquires such an interest within ten years. If he adheres to the agreement and does not make a reacquisition, the redemption can qualify under 302 by virtue of section 302(c)(2).

Section 302(b)(1) provides that if a redemption does not fit into any of the "safe harbors" (302(b)(2), (3), or (4)), it will be treated as a sale rather than a distribution if it is *not* "essentially equivalent to a dividend." These words are the same as those found in the 1939 Code as the sole test for whether there would be dividend or exchange treatment. Until 1970 most of the decisions under the 1939 Code were considered relevant in applying that test under the 1954 Code. For example, if there was an essentially pro rata redemption in a transaction with a bona fide business purpose, many courts held that the transaction was not essentially equivalent to a dividend and permitted exchange treatment.

The fact situation in *United States v. Davis* was typical. The shareholder, his wife, and his two sons each owned 25 percent of the common stock of the corporation. The shareholder owned all the preferred stock. The preferred stock originally had been issued to build up capital to qualify the corporation for a Reconstruction Finance Corporation loan. This intention was clearly documented, and it was contemplated that when the corporation achieved firmer financial standing the preferred would be, and in fact was, redeemed. The parties agreed that there was a bona fide business purpose for the transaction. The Supreme Court carefully considered the legislative history of the 1954 Code and concluded that there was no intention to carry over the decisions under the 1939 Code. To the extent that the 1939 Code embraced certain concepts in the area of corporate contractions, Congress was deemed to have included those under partial liquidations. Basically, the Court stated that the only test of dividend equivalence was whether or not the distribution in redemption was pro rata.

It was also held that the attribution rules must be taken into account under 302(b)(1). Under these rules, Mr. Davis was considered to be the sole shareholder of the corporation both before and after redemption. The Court said that in any case where someone is deemed the sole shareholder at both these times, the payment is essentially equivalent to a dividend. There must be a meaningful reduction in the shareholder's proportionate interest in the corporation to qualify under 302(b)(1) after the attribution rules are applied. In dissent, Justice Douglas stated that 302(b)(1), as a practical matter, would be useless after the *Davis* case, and the extremely limited scope given the section by subsequent decisions affirms this view.

Three sections remain to be considered. The section 303 redemption, which is an exception to dividend treatment in the case of a redemption to pay death taxes, is discussed by Professor Schoenfeld. Section 304 basically states that, if shareholders are in control of two corporations, and one of the corporations buys stock in the other from those shareholders, the transaction may be treated as a constructive redemption. In such a situation, sections 301 and 302 may apply if all the tests are met. Also, with one important exception, attribution rules apply – the 50 percent limitation on corporate attribution does not. Section 304 covers another type of constructive redemption, where a subsidiary purchases its parent's shareholders' stock in the parent. Again, if the tests are met, the Code provides that the transaction should be considered as if the subsidiary had paid the money to the parent and the parent, in turn, had redeemed its shareholders' stock.

Finally, section 306 deals with the preferred stock bail-out. This provision covers the situation where a corporation distributes a preferred stock dividend on common stock (usually tax free under section 305) and then has the shareholders sell the stock to an institution interested in buying it directly from the corporation. If implemented, the plan would provide the shareholders with cash and a retention of ownership of 100 percent of the common stock of the corporation. This preferred stock bail-out is characterized as "section 306 stock".

Upon a sale of section 306 stock, the proceeds, regardless of gain or loss, are taxed as ordinary income to the extent of the shareholder's proportionate share of earnings and profits existing at the time he received the stock dividend. One may receive section 306 stock in other ways, for example, in a reorganization which has the effect of a stock dividend or in an exchange for other 306 stock. If section 306 stock is owned and, instead of being sold, it is redeemed after five or ten years, the transaction is treated as a section 301 transaction at that point in time. Thus, if earnings and profits have built up in the interim, the measure of tax on the redemption relates to the earnings and profits at the later date. In other words, there can be a large "dividend" at the time of the redemption even though an actual cash dividend at the time of the stock dividend would have been treated as a return of capital.