INTRODUCTION AND STUDY OBJECTIVES

After a corporation is organized, the shareholders seek to share in its financial success. When a corporation obliges its shareholders by distributing money or property (other than stock) to them, the shareholders must treat the distribution as either an ordinary taxable dividend, a return of their capital investment, or a capital gain. The major factor in determining how the distribution is treated is whether or not it is paid out of earnings and profits.

In studying the rules of corporate distributions, the student should have these objectives:

1. To learn the general pattern and the corresponding tax effects of a distribution.
2. To grasp the notion of earnings and profits and to learn how it is computed.
3. To become familiar with the distribution rules pertaining to stock and stock rights.
4. To understand the tax ramifications of receiving a constructive dividend.

STUDY HIGHLIGHTS

SECTION 301: DISTRIBUTIONS IN GENERAL

1. Section 301 establishes the statutory framework for distributions as follows:
   - To the extent of current and accumulated earnings and profits, a distribution is treated as a dividend.
   - Any excess distributions are treated as a tax-free return of capital to the extent of the shareholder’s basis.
   - Any excess over basis is treated as a capital gain.

Example. An investor buys 10 shares of stock for $1,000, a price that reflects the proportionate share of corporate capital of $800 plus retained earnings and profits of $200 attributable to those shares. If the corporation should immediately distribute cash of $500, even though the investor may be regarded as getting back half of his capital, the shareholder has realized dividend income to the extent of $200, the corporate earnings and profits. The balance of $300 is treated as a return of his $1,000 investment, reducing the basis of his shares to $700.

2. The term earnings and profits (E&P) is not defined in the Code, nor is it necessarily the same as retained earnings (although they could be the same). Over the years, the IRS and Courts have developed guidance in determining the measure of E&P.
3. It is important to distinguish between the current year’s E&P and accumulated E&P from prior years. The starting point for current E&P is taxable income. The following formula illustrates the computation:

\[
\text{Current earnings and profits [or deficit]} = \text{Current taxable income or loss} + \text{Exempt and nondeferrable income} - \text{Items not deductible in computing taxable income} + \text{Deductions not permitted in computing taxable income}
\]

See Exhibit 3-2 for a more extensive and complete list of adjustments and Exhibits 3-4, 3-5, and 3-6 for the Alternative Depreciation System (ADS) straight-line method, which must be used for post-86 ACRS depreciation.

4. Accumulated E&P is nothing more than the accretions to E&P created by the prior years’ undistributed current E&P.

5. To be subject to income tax as a dividend, a distribution must be paid out of earnings and profits for the current year or earnings and profits accumulated after February 28, 1913. There will always be a taxable dividend if earnings exist in either the current or accumulated account.

**Example.** B Corp. is incorporated with an initial investment of $80,000 in cash. It used part of the cash to acquire land with a cost of $9,000. At the end of the first year, the land doubled in value. The corporation had no earnings or business activity in that year; therefore, a distribution of $9,000 out of the appreciation surplus would not qualify as a taxable dividend as there was no source of realized E&P. The distribution would therefore be considered a return of the capital investment.

6. If the current year’s E&P is sufficient to cover all distributions made during the year, each distribution is a taxable dividend. But if the cash distributions exceed current E&P, a part of the E&P must be allocated proportionally to each distribution. Accumulated E&P is allocated to distributions made in chronological order.

7. If there is a deficit in current E&P, it is prorated on a daily basis against accumulated E&P. If there is a deficit in accumulated E&P and positive current E&P, the deficit is ignored. If there is a deficit in both accumulated and current E&P, no dividend can exist.

**Example.** Y, a calendar year corporation, has a deficit of $10,000 in its E&P account at the beginning of its taxable year 2008. For calendar year 2008, it has current E&P of $5,000. Should the corporation distribute $5,000 to its sole shareholder, A, on July 1, 2008, the distribution would be taxed as a dividend to A since it is considered to have been paid out of the current E&P of $5,000. At the end of the year, the corporation still has an accumulated deficit in E&P of $10,000. If Y had waited until 2009 to make the $5,000 distribution, and if it had not generated “current” E&P in 2009, the distribution would be treated as a return of capital. This is because the earnings for 2008 would be absorbed by the accumulated deficit, leaving no accumulated earnings to support dividend treatment in 2009.

**DISTRIBUTIONS OF PROPERTY**

8. Distributions are not always made in the form of cash. In many cases, a shareholder receives an in-kind property distribution. To determine the tax effect of a property distribution requires the determination of the amount of the property and the basis of the property received.
9. Prior to 1987, distributions by corporations usually avoided double taxation (i.e., once at the corporate level and a second time at the shareholder level) under a doctrine known as General Utilities. Over a period of time, application of the General Utilities doctrine slowly eroded with special provisions enacted to cause double taxation in certain instances. Finally, in the Tax Reform Act of 1986, Congress eliminated the avoidance of double taxation.

10. Section 311 after 1986 provides that a corporation must recognize gain upon the distribution of property other than its own obligations. The gain to be recognized is computed as if the corporation had sold the property to the distributee shareholders for its fair market value. Losses on a distribution are not recognized to prevent taxpayers from circumventing the basic income recognition rules and distributing loss assets to shareholders whenever the corporation desires to reduce its income. The no loss rule also prevents taxpayers from creating artificial losses while property is still within their control.

11. When property subject to a liability is distributed, the corporation is relieved of an obligation. When this is the case, § 311(b)(2) provides that the fair market value of the property is deemed to be no less than the amount of the liability.

12. When a distribution of property is made, § 312 requires that the corporation’s E&P must be reduced by the adjusted basis of the property distributed but never below zero. There are, however, additional rules that must be recognized:

- **Liabilities:** The reduction in E&P must be reduced by the amount of liabilities distributed (i.e., a smaller charge to E&P).

- **Appreciation:** E&P must be increased by the fair market value in excess of basis and subsequently reduced by the property’s fair market value.

- **Obligations:** When a corporation distributes its own obligations, E&P is reduced by the “issue price” (value) of the obligation.

13. For a noncorporate shareholder, the amount of any property distribution is the fair market value of the property received. The basis for the property is also its fair market value on the date of distribution. The holding period begins on the date of distribution.

**Example.** S and O, individuals, each own half of the stock of L Corporation, which has E&P of $100,000. L distributes property having a basis of $60,000 and a FMV of $160,000 to its shareholders, each receiving property with a basis of $30,000 and a FMV of $80,000. As a result of the distribution, E&P is increased by the appreciation of $100,000 ($160,000 − $60,000). Thus, the taxable amount to each shareholder as dividends is $80,000, the FMV of the property received.

14. For a corporate shareholder, the amount of the distribution as well as its basis is the lesser of the fair market value of the property received or the distributor’s adjusted basis plus any gain recognized by the distributing corporation. The holding period for the property depends upon whether the dividend was determined based upon its fair market value or its adjusted basis to the distributing corporation.

**Example.** R Corporation and T, an individual, each own half of the stock of S Corporation, which has E&P of $40,000. S distributes to each shareholder property having a basis of $6,000 and a FMV of $16,000, thereby causing $10,000 of gain to be recognized. R reports $16,000 ($6,000 + $10,000) as the amount of its distribution, all of which is taxed as dividend income. T, having received the same property, must include $16,000 (the FMV) as dividend income. Thus, after the Tax Reform Act of 1986, the end result is essentially the same regardless of the technique or formula used for corporate or noncorporate distributions.
CONSTRUCTIVE DIVIDENDS

15. To be treated as a dividend, a distribution must be made to a shareholder with respect to his stock. However, a dividend need not be declared in a formal manner. Informal benefits provided to a shareholder may be taxed as a constructive dividend. These constructive dividends must be included in the shareholder’s gross income.

16. Excessive or unreasonable compensation is often asserted by the IRS as a constructive dividend. Since the DRA of 1984, this includes interest-free loans made to shareholders as well. When excessive compensation exists, the IRS converts the excessive compensation to dividend income and the corporation loses its compensation deduction. Beginning in 1994, publicly held corporations cannot deduct compensation in excess on one million dollars.

17. Corporate loans to shareholders will be deemed a dividend if there was no intent to create a valid debtor-creditor relationship. Even if a loan is genuine, forgiveness a year later will convert the debt to a dividend at that time.

18. Other constructive dividends include payments for a shareholder’s benefits; a shareholder’s use of corporate property and bargain purchases are two common examples.

DISTRIBUTIONS OF STOCK AND STOCK RIGHTS

19. Under § 305(a) a distribution of a corporation’s own stock to the shareholders is generally tax-free. Certain exceptions do exist that make the distribution taxable to the shareholder. These include:

- Distributions in lieu of money (i.e., the shareholder had the option of taking money instead of stock)
- Disproportionate distributions
- Distributions of both common and preferred stock
- Distributions of preferred stock
- Distributions of convertible preferred stock

20. If a stock dividend is taxable, the basis in the stock is equal to its fair market value on the date of the distribution. If the stock dividend is nontaxable, the basis must be allocated based upon relative weighted fair market values. For an example of the allocation procedure, see Exhibit 3-7 of the textbook.

21. Stock rights are treated in a similar manner to stock dividends. Nontaxable stock rights require an allocation of basis—taxable rights have a basis equal to fair market value. Once again, see Exhibit 3-7 of the textbook.

22. The holding period of nontaxable stock rights and stock dividends includes the holding period of the underlying stock. Taxable stock rights and stock dividends have a holding period that begins on the date of distribution. For stock rights that are exercised, the holding period begins on the date of exercise.
STUDY QUESTIONS

True or False

1. Amounts that are not considered dividends because of inadequate earnings and profits are treated as a nontaxable return of capital.

2. A nontaxable stock dividend has no effect on the corporation’s ability to pay dividends and, consequently, the E&P balance is unaffected.

3. Distributions made during the year are taxable to the extent of accumulated earnings and profits first and from current earnings and profits second.

4. Section 311 applies only to dividend type distributions, not to redemption-related distributions.

5. If a corporation’s distribution of property includes a liability to be assumed by the taxpayer, the corporation’s E&P is reduced by the amount of the liability.

6. Excessive compensation paid to a shareholder-employee will be treated as a constructive dividend.

7. When a corporation distributes rights to acquire its own stock, the distribution is taxable.

8. A stock dividend will reduce the E&P of a corporation.

9. A corporation that distributes depreciable property will have to recognize gain to the extent of § 1245 or § 1250.

10. Current E&P must be apportioned to all distributions that are made during the tax year.

11. A shareholder that purchases land (capital asset) from its controlled corporation for $43,000 (FMV of the land is $60,000) will have to recognize a capital gain of $17,000.

12. The amount of distribution received by a noncorporate shareholder from a corporation is any money received plus the fair market value of other property received.

13. Corporation C makes a cash distribution to its shareholders. C’s earnings and profits should be reduced by this cash distribution, but not below zero.

14. T Corporation, with earnings and profits of $10,000, distributed $15,000 to A, the sole owner of the corporation. If the adjusted basis of A’s stock is $12,000, she should include $10,000 as dividend income and $5,000 as capital gain on her income tax return.

15. Earnings and profits of a corporation cannot be reduced below zero by a distribution of cash or property.

16. If a corporation distributes property that is subject to a liability in excess of its basis, no gain must be recognized by the corporation on the distribution.

17. Earnings, and profits and retained earnings are computed in the same manner.

18. A corporation that uses modified ACRS depreciation for tax purposes will have to recompute depreciation for E&P purposes.
3-6  Corporate Distributions: Cash, Property, and Stock Dividends

Multiple Choice

1. A distribution of stock or stock rights is generally considered a dividend unless it is which of the following?
   a. Distribution in lieu of money.
   b. Proportionate distribution.
   c. Distribution with respect to preferred stock.
   d. Distribution of convertible preferred stock.
   e. Disproportionate distribution of common and preferred stock.

2. A corporation with earnings and profits of $200,000 distributes a building with an adjusted basis of $120,000 and a fair market value of $180,000 to its sole shareholder. The building had a mortgage of $70,000 that the shareholder will assume. What is the amount of the dividend received by the shareholder?
   a. $50,000.
   b. $110,000.
   c. $120,000.
   d. $180,000.
   e. $200,000.

3. Based on the following facts, what is the amount of Corporation X’s current-year earnings and profits?

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income per return:</td>
<td>$100,000</td>
</tr>
<tr>
<td>Federal income tax per return:</td>
<td>38,000</td>
</tr>
<tr>
<td>Tax-exempt interest income:</td>
<td>22,000</td>
</tr>
<tr>
<td>Contributions included in item 1 above:</td>
<td>2,000</td>
</tr>
<tr>
<td>Political campaign contribution (not deducted):</td>
<td>1,000</td>
</tr>
</tbody>
</table>

   a. $22,000.
   b. $62,000.
   c. $83,000.
   d. $84,000.
   e. $110,000.

4. On December 31, 2009, K Corporation distributed to its sole individual shareholder a tract of land that was not an inventory asset. Immediately prior to the distribution on December 31, 2009, the following data were available:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis of the land:</td>
<td>$30,000</td>
</tr>
<tr>
<td>Fair market value of the land:</td>
<td>$25,000</td>
</tr>
<tr>
<td>Accumulated earnings and profits:</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

   By how much should the dividend distribution reduce K Corporation’s accumulated earnings and profits?

   a. $20,000.
   b. $25,000.
   c. $30,000.
   d. $35,000.
   e. None of the above.
Questions 5 through 7 are related.

A Corporation, which has earnings and profits of $20,000, distributes to its sole stockholder property having a basis to the corporation of $10,000 and a FMV of $25,000. Assume that the basis of the shareholder’s stock is $22,000.

5. Based upon the information furnished, determine the amount that is taxable to the shareholder as an ordinary dividend.
   a. None.
   b. $10,000.
   c. $20,000.
   d. $25,000.

6. Based upon the same information, determine the amount that is taxable to the shareholder as capital gain.
   a. None.
   b. $3,000.
   c. $5,000.
   d. $15,000.

7. Determine the basis of the stock to the shareholder after making the above distribution.
   a. None.
   b. $17,000.
   c. $19,000.
   d. $22,000.

8. Calendar year T Corporation’s earnings and profits for its first year of operations were $22,000. In December, it distributed to its individual stockholders $10,000 in cash and land with a basis of $14,000—fair market value of $25,000 at the date of distribution. Prior to the distribution, the stockholders’ tax basis for their investment in the corporation was $76,000. What was the stockholders’ adjusted basis at the end of the year?
   a. $51,000.
   b. $52,000.
   c. $63,000.
   d. $74,000.
   e. None of these.

9. On June 30, 2009, R Corporation had earnings and profits of $1 million. On that date, it sold a plot of land to a stockholder for $50,000. R had paid $40,000 for the land in 1979, and it had a fair market value of $80,000 when the stockholder bought it. What was the amount of dividend income taxable to the stockholder in 2009?
   a. $10,000.
   b. $20,000.
   c. $30,000.
   d. $40,000.
   e. $80,000.
10. Assuming current earnings and profits are computed by making certain modifications to current taxable income, which of the following is false?
   a. An adjustment is required if the corporation maintains its inventory using the LIFO method.
   b. No adjustment is needed if capital losses exceed capital gains.
   c. An adjustment is required when the installment sales method is elected.
   d. An adjustment is required when the corporation sells property to its sole shareholder at a loss.
   e. An adjustment is necessary if MACRS is used.

11. HIJ Corporation had a balance of $100,000 in accumulated earnings and profits at the beginning of the year. During the current year it had a deficit in current earnings and profits of $73,000, which was attributable to poor performance throughout the year. The corporation made two distributions during the year: $60,000 on February 1 and $40,000 on December 1. The distributions will be treated as follows:
   a. A maximum of $27,000 of the distributions will be treated as a dividend.
   b. A portion of both the first and second distribution will be treated as a dividend.
   c. Only the first distribution will give rise to dividend income.
   d. Neither of the distributions will give rise to dividend income, since there are no current earnings and profits.
   e. None of the above is true.

12. ABC Corporation’s beginning balance of accumulated earnings and profits is a deficit of $100,000 and had current earnings and profits of $20,000. On March 1, the corporation distributed $45,000 to its sole shareholder, R, who had a basis in his stock of $30,000. R will report
   a. no dividend income and a capital gain of $15,000.
   b. a dividend of $20,000.
   c. a dividend of $20,000 and a capital gain of $25,000.
   d. no dividend income and a capital gain of $25,000.
   e. none of the above.

13. L is the sole shareholder of the X Corporation. L has received advances from the corporation totaling $20,000. X did not charge any interest on the advances when the going rate was 9 percent. Which of the following statements is false?
   a. L may be charged with a dividend of approximately $1,800 but may have an offsetting interest expense deduction of an equivalent amount.
   b. L may be charged with a dividend of $20,000 but may have an offsetting interest expense deduction of an equivalent amount.
   c. L may be charged with additional compensation of approximately $1,800 but may have an offsetting interest expense deduction of an equivalent amount.
   d. All of the above are true.
   e. All of the above are false
14. Which of the following statements is true?

a. Before a shareholder is charged with dividend income there must be a formal declaration by the corporation’s board of directors of its intent to make a dividend distribution.
b. Assuming a corporation makes a $5,000 interest-free loan to a corporate executive who is also a shareholder, the mechanics of the governing provisions may impute a nondeductible dividend payment made by the corporation to the individual.
c. Assuming a corporate executive, who also is a 40 percent shareholder, is given free use of the company car, the use attributable to personal purposes may be deemed a dividend.
d. It is not necessary to have E&P to have a constructive dividend.
e. All of the above are true.

Fill In the Blanks

1. A distribution, under the statutory framework, is first treated as a, _______ , next as a _______, and finally as a ______.
2. A distribution is treated as a dividend to the extent of _______ and _______.
3. Current E&P is _______ for multiple distributions, while distributions out of accumulated earnings and profits are assigned in _______.
4. Distributions of property are referred to as _______ distributions.
5. When a corporation distributes a liability, it serves to _______ earnings and profits.
6. The basis to a shareholder of a property distribution is the _______ of the property distributed by the corporation.
7. Excessive or unreasonable compensation will be treated as a _______ dividend to the shareholder employee.
8. A distribution of a corporation’s own stock is generally _______ to the shareholder.

Code Section Recognition

For each of the following Code sections, try to match the response that most properly identifies the underlying provision.

1. § 301 a. effects on earnings and profits
2. § 305 b. taxability of corporate distributions
3. § 311 c. distributions of stock dividends
4. § 312 d. property defined
5. § 316 e. distributions to shareholders
6. § 317 (a) f. dividend defined
True or False

1. True.

2. True.


4. False. Section 311 now applies to both distributions and redemptions.

5. False. The overall effect is an increase to earnings and profits.

6. True.

7. False. The transfer is tax-free and results in basis allocations.

8. False. Stock dividends have no effect on earnings and profits.


10. True.


12. True.

13. True.

14. False. $10,000 as dividend income and $5,000 as return of basis.

15. True. Only a deficit for the year can reduce E&P below zero.

16. False. Under the repeal of General Utilities, all property that has a FMV in excess of its basis will generate a gain to the distributing corporation.

17. False. Although the amounts could possibly be the same, the amounts are computed in a different manner.

18. True. Under § 312(k), the corporation must recompute depreciation for E&P purposes.
Multiple Choice

1. b.

2. b. $180,000 FMV – $70,000 liability = $110,000.

3. c. $100,000 – $38,000 + $22,000 – $1,000 + $83,000.

4. c. Basis of the property.

5. d. FMV. $20,000 Beginning E&P + $15,000 gain ($25,000 – $10,000) = $35,000 balance in E&P. Thus, full FMV is taxable.

6. a. All previously taxed as a dividend.

7. d. $22,000. No change in basis.

8. c. $76,000 basis – $13,000 [$22,000 – $10,000 – 25,000] = $63,000.

9. c. $80,000 FMV – $50,000 sales price = $30,000.

10. b. E&P must reflect the economic loss. An adjustment must be made.

11. c. The first distribution absorbs all of the E&P.

12. b. Taxed to the extent of current E&P.

13. b. a and c are both true statements.

14. c. There is no requirement that a formal declaration be made to have a dividend.

Fill In the Blanks

1. Dividend; return of capital; capital gain.

2. Earnings; profits.

3. Prorated; chronological order.

4. In-kind.

5. Increase.

6. Fair market value.

7. Constructive.

8. Nontaxable or tax-free.
3-12 Corporate Distributions: Cash, Property, and Stock Dividends

Code Section Recognition

1. e.
2. c.
3. b.
4. a.
5. f.
6. d.