TAX MANAGEMENT
PORTFOLIOS™

U.S. INCOME

Current Distributions — Cash and Property

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Current Distributions — Cash and Property

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Current Distributions — Cash and Property*, No. 764-4th, discusses the tax consequences of distributions, of either cash or other property (in kind distributions), from a distributing corporation to its shareholders. Distributions made from a corporation's earnings are generally referred to as taxable dividends.

If a corporation makes a distribution, the amount received by its shareholders is taxable as a dividend (taxed as either net capital gain or ordinary income), to the extent the distribution is made out of the corporation's earnings and profits. A distribution in excess of earnings and profits reduces the shareholder's basis in its stock; any residual amount of the distribution is treated as gain from the sale or exchange of property. Individuals report the receipt of "qualified dividend income" as capital gain. Corporate shareholders may use the dividends received deduction to reduce the amount of the distribution treated as a dividend from its taxable income in the year of the distribution depending on the level of the corporate shareholder's ownership of the distributing corporation.

Distributions of property, other than cash, may cause the distributing corporation to recognize gain (but not loss) under §311 on distributions where the fair market value is greater than the tax basis of the assets distributed.

In addition to discussing the pertinent Code and regulation provisions that set forth the rules regarding corporate distributions, this Portfolio analyzes: (1) the taxability of dividend distributions to both corporate and noncorporate distributees; (2) the dividends received deduction for both domestic and foreign owned corporations; (3) the basis reduction and gain recognition for extraordinary dividends under §1059; (4) the tax effect on the distributing corporation of dividends in kind; (5) corporations filing consolidated returns receiving and paying distributions; (6) the reporting and withholding requirements associated with corporate distributions; and (7) the interaction of dividend treatment with redemptions as it relates to the excise tax for share buybacks.

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DETAILED ANALYSIS

I. Introduction

A. Two Tiers of Tax

The United States uses the "classical" system of corporate income taxation, in which a corporation and its shareholders are taxed separately.[1] Under the classical system, corporations are subject to the corporate income tax on all earnings, while shareholders generally are taxable upon actual distributions of corporate earnings.

The following simplified example illustrates the cumulative effect of the U.S. two-tier system.

> *Example:* Assume a corporate tax rate of 21%[2] and an individual income tax rate of 37%.[3] Domestic Corporation X pays tax of $210,000 on its taxable income of $1 million. X distributes all $790,000 of its after-tax earnings to its sole shareholder, individual T. Assume that T is married, filing a joint return. Qualified dividends are taxed at capital gains rates. Using a 20% capital gains rate, the second level (shareholder level) of tax in this example would be $158,000, for an overall effective rate of 36.8%. In addition, the qualified dividend income would likely be subject to the net investment income tax (NIIT, which is an additional 3.8%). Thus, the overall effective rate if the NIIT is incurred is 39.8%. If the distribution is not a qualified dividend and, therefore, is taxed at ordinary income rates, T will pay $322,320 of tax on the distribution (assuming that T is subject to the highest individual tax rate of 37% and the distribution is subject to the NIIT), resulting in an overall effective tax rate of approximately 53.2%.

As illustrated in this example, qualified dividend income received by noncorporate taxpayers is taxed as net capital gain.[4] Qualified dividend income generally means dividends from domestic corporations and from certain foreign corporations.[5] For a detailed discussion of "qualified dividend income," see V.A.2., below. Dividend income received by a noncorporate shareholder that is not qualified dividend income is taxed as ordinary income.

As a result of this "double" taxation, it is little wonder that the U.S. system faces continual pressure from tax strategies seeking to eliminate one level of tax on corporate earnings. Generally, U.S. corporations seek to recharacterize corporate distributions as something other than dividends, such as compensation or interest. If the recharacterization is successful, the corporate payor can deduct the payment in question, thus eliminating one level of tax.

B. Capital Gains Rates Applicable to Qualified Dividend Income

As stated above, qualified dividend income received by noncorporate taxpayers is treated as net capital gain.[6] For tax years beginning in 2013 through 2017, the applicable long-term capital gains rates (which apply to qualified dividends) are as follows: 0% for individuals in the 10% or 15% ordinary income tax brackets; 15% for individuals in the next four brackets — 25%, 28%, 33%, and 35%; and 20% for individuals in the 39.6% tax bracket.

For tax years beginning after 2017, the income thresholds for the capital gains rates are slightly different from the ordinary income tax bracket thresholds. The income thresholds for the capital gains rates — set forth in §1(j)(5) — are as follows:

- The 0% rate applies to a joint return or return of surviving spouse with taxable income under $77,200, a head of household return with taxable income under $51,700, a return of any other individual (other than an estate or trust) with taxable income under $38,600, and returns of estates and trusts with taxable income under $2,600.[7]

- The 15% rate applies to a joint return or return of surviving spouse with taxable income under $479,000, a return of head of household with taxable income under $452,400, a return of any other individual (other than an estate or trust) with taxable income under $425,800, and returns of estates and trusts with a taxable income under $12,700.[8]

- All other noncorporate filers are subject to a 20% rate on qualified dividends.[9]

The income thresholds are adjusted annually for the cost of living (inflation).[10]

C. Application of the Net Investment Income Tax

Dividend income, except to the extent excluded by the ordinary course of a trade or business exception, is considered "net investment income" for purposes of §1411. Section 1411 imposes an additional 3.8% tax on the lesser of: (a) the taxpayer's net investment income for the tax year; or (b) the excess of the taxpayer's modified adjusted gross income for the year over a threshold amount. The threshold amounts for §1411 purposes are $250,000 for taxpayers filing joint returns and surviv-

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[1] This Portfolio discusses the treatment of C corporations, i.e., those corporations generally subject to the rules of Subchapter C of the Code. The term "corporation" includes associations, joint-stock companies, and insurance companies and other entities that elect to be taxed as C corporations. *See* §7701(a)(3); Reg. §301.7701-1 *et seq.* All section references herein are to the Internal Revenue Code of 1986, as amended, and to the regulations thereunder unless otherwise stated. For a discussion of S corporations, see 730 T.M., *S Corporations: Formation and Termination*, and 731 T.M., *S Corporations: Corporate Tax Issues.*

[2] §11(b).

[3] §1(j)(2).

[4] §1(h)(11).

[5] §1(h)(11)(B). There are certain exceptions from the general rule, discussed in V., below.

[6] §1(h)(11).

[7] §1(j)(5)(B)(i).

[8] §1(j)(5)(B)(ii).

[9] §1(h)(1)(D).

[10] §1(j)(5)(C).

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ing spouses, $125,000 for a married taxpayer filing a separate return, and $200,000 for all other taxpayers. For a detailed discussion of the NIIT, see 511 T.M., *Net Investment Income Tax*.

D. Corporate Shareholders — Dividends Received Deduction

Corporate shareholders have an even greater need for relief from dividend taxation. The basic corporate income tax structure imposes a tax on income and then a subsequent tax on the shareholder upon receipt of a corporate distribution of that income. Absent the relief, layers of corporate shareholders would create a system of multiple levels of taxation. Consequently, the U.S. tax system provides a dividends received deduction (DRD) that allows corporate shareholders to reduce the amount of a distribution treated as a dividend depending on the level of the corporate shareholder's ownership of the distributing corporation. The dividends received deduction has produced abuses, and, as a consequence, other Code sections have been enacted to limit those abuses without repealing the dividends received deduction.

Comment: The consolidated return regulations are usually considered the ultimate antidote to multiple taxation of corporate income because of their complete exclusion for intercompany distributions among the members of the consolidated group.[11] It is interesting, therefore, that the 1909 enactment of the dividends received deduction actually predated the initiation of consolidated returns in 1917.

E. Scope of Portfolio

This Portfolio focuses on corporate nonliquidating distributions of cash, property, and deemed distributions to shareholders.

In general, when a distribution is made out of the earnings and profits of a corporation, the amount received (a dividend) is taxable as ordinary income or as qualified dividend income. When distributions are made in excess of the corporation's earnings and profits, the recipient ordinarily is not taxed to the extent of the recipient's basis in the stock. Distributions in excess of earnings and profits and basis normally are taxed as if the shareholder had sold the stock. See II., below.

In addition to knowing how a corporate distribution is taxed, the recipient needs to know when to include the dividend in income and what the recipient's tax status is for the distributed asset. For example, the distributee needs to know the recipient's basis in the asset as well as the holding period. See III. through V., below.

As mentioned above, the tax treatment for individual shareholders differs from that of corporate shareholders. The extra threat of multiple tax on earnings when there are corporate shareholders requires special rules and then further exceptions to combat the areas of perceived abuse. See VI. and VII., below.

Section 311 contains the rules governing the tax effect on the distributing corporation of the distribution of property. Under §311, corporations generally recognize gain (but not loss) on distributions of property to their shareholders. See VIII., below.

Transactions among members of a consolidated group are subject to special rules in the consolidated return regulations. The regulations on dividend distributions are discussed in IX., below.

As described above, distributions to corporate and individual shareholders may be eligible for relief from taxation in certain circumstances. As such, taxpayers may seek to manipulate stock sales and distributions to gain the most tax advantages. For example, corporate shareholders may prefer a distribution of earnings by way of dividend (thus producing a dividends received deduction) immediately before a sale of the stock of the distributing corporation (which otherwise would result in gain to the corporate shareholders to the extent fair market value exceeds adjusted basis). Thus, distributions made in close temporal proximity to stock sales often receive increased scrutiny from the IRS. See X., below.

The Portfolio also discusses the general reporting and withholding requirements pertinent to distributions. See XI., below.

[11] Reg. §1.1502-13(f)(2)(ii) ("[a]n intercompany distribution is not included in the gross income of the distributee member …").

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II. Definition of "Dividends"

A. *"Dividends" vs. Other Taxable Payments*

Many taxpayers receive taxable payments from corporations in exchange for goods and services: employees receive wages for their services;[12] landlords receive rent for the use of their real property;[13] creditors receive interest for the use of their capital;[14] and, of course, shareholders may receive dividends for the use of their capital.[15] Most of these payments receive ordinary income treatment, for tax purposes, without regard to the profitability of the corporate payor. Shareholder recipients, however, find that their tax treatment is a function of the profitability of the corporate payor (in a tax, if not always an economic, sense).

The measure of the profitability of the corporate payor is based on the amount of a corporation's earnings and profits, a concept intended to measure the economic income of a corporation available for distribution as profits.[16] If a distribution to shareholders is less than or equal to corporate earnings and profits, it is a dividend within §316 (i.e., a distribution of profits) and is includible in gross income.[17] For individual shareholders, qualified dividend income is taxed as net capital gain.[18] To the extent the distribution exceeds corporate earnings and profits, it is treated as a return of capital, reducing each distributee's stock basis.[19] To the extent the amount distributed exceeds the shareholder's stock basis, the excess is treated as capital gain from the sale or exchange of the stock.[20] The determination of whether a distribution constitutes a dividend, a return of capital, or gain from a sale or exchange has significant tax implications for individual shareholders.

For corporate shareholders, dividend status similarly is determined by the amount of the distributing corporation's earnings and profits. Income tax treatment for corporate shareholders, however, primarily depends on the availability of the dividends received deduction (DRD) and any limitations with respect to the DRD.

[12] §61(a)(1).

[13] §61(a)(5).

[14] §61(a)(4).

[15] §61(a)(7).

[16] *See* H.R. Rep. No. 98-861, at 835 (1984) (Conf. Rep.) (Tax Reform Act of 1984).

[17] *See* §301(c)(1), §61(a)(7). *See generally* PLR 199933040 (distribution by holding company, which was created solely to effect transaction, to its shareholders was includible in shareholder's gross income to extent made from holding company's accumulated earnings and profits), PLR 9626023 (distribution to shareholders of excess cash raised in initial public offering taxable under §301(c)(1) to extent it was made from current or accumulated earnings and profits).

[18] *See* §1(h)(11). See also the discussion in I., above, concerning tax rates and the additional 3.8% tax that will likely apply to dividends pursuant to §1411.

[19] §301(c)(2).

[20] §301(c)(3)(A). Section 301(c)(3)(B) contains a minor refinement of this rule for corporations with pre-1913 earnings: if the distribution is treated as coming out of a pre-1913 increase in value, it is tax exempt to the distributee.

B. *Tax Definition of "Dividend"*

1. *Overview*

In order to qualify as a dividend for tax purposes, there are three general requirements: (i) the distribution must be made out of earning and profits; (ii) the distribution must be made to a person in a shareholder capacity; and (iii) there must be a distribution of property to the shareholder.[21]

a. *Distributions Must Be Made Out of Earnings and Profits*

The starting point for determining the tax consequences to a shareholder of a corporate distribution is to determine if the distribution is a dividend for tax purposes. Section 316(a) defines "dividend" as a distribution out of either the corporation's current or accumulated earnings and profits. This two-pronged test is a setback for the cause of simplicity[22] and derives more from tax history than tax policy. The test leads to the anomaly known as a nimble dividend where a corporation with an accumulated deficit in earnings and profits can pay a dividend, for tax purposes, by distributing the amount in a year with current earnings and profits.

When a cash distribution taxed as a dividend is made to shareholders in the nimble dividend context, the effects may be unexpected but appropriate as the shareholders receive cash from current earnings. The more difficult situation occurs when the distribution consists of property that has a built-in gain. As described in more detail in VIII.B.1., below, a corporation must recognize gain (but not loss) on property distributed under §311(b). This gain can contribute to, and even create, current earnings and profits with the shareholder recognizing the fair market value of the distribution into income without receiving any cash to pay the taxes. The treatment can be particularly harsh when the stock of a subsidiary is distributed to its shareholders in a transaction that does not qualify as tax-free under §355. The operative rule for reducing earnings and profits under §312 reduces earnings and profits by the distributed property's value or greater adjusted basis, unless received in a redemption that is treated by the shareholder as a sale under §302(a), in which §312(n)(7) applies. The corporate earnings and profits, however, are not reduced for the distribution of property that the shareholder treats as nonrecognition property under §312(d)(1). The wording of this section is vague, making the certainty of the treatment of a distribution of stock difficult. Section 312(d)(1) states:

> The distribution to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property, in a distribution to which this title applies, shall not be considered a distribution of the earnings and profits of any corporation —

[21] §316(a).

[22] *See* Staff of Senate Comm. on Finance, "The Reform and Simplification of the Income Taxation of Corporations: A Preliminary Report," at 77 (Comm. Print 1983).

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(A) if no gain to such distributee from the receipt of such stock or securities, or property, was recognized under this title, or

(B) if the distribution was not subject to tax in the hands of such distributee by reason of section 305(a).[23]

The statute exempts distributions of stocks, securities or other property from reducing earnings and profits if no gain to the distributee "was recognized under this title." The reference to "title" is unclear and might cause confusion as some taxpayers might not have a gain but for the deemed gain on the distribution.

For most corporations, the two-pronged test is unnecessary because they have sufficient current earnings and profits to cover distributions and, thus, to generate dividend treatment to shareholders. Even corporations with a deficit in current earnings and profits may have sufficient accumulated earnings and profits to cover distributions. The statutory search for accumulated earnings and profits to cover distributions ends at March 1, 1913; earnings and profits accumulated before that date do not support dividend treatment.[24] Corporations with a deficit in both current and accumulated earnings and profits can make distributions to shareholders that escape the dividend definition in the year of the distribution and are either a return of capital or are treated as capital gains.[25] Alternatively, a corporation with current earnings and profits and an accumulated deficit in earnings and profits that is greater than the current earnings and profits could plan for a distribution in the following year if no current earnings and profits are projected to avoid dividend taxation if the netting would produce an accumulated deficit.

b. Distributions Must Be Made to Person in Shareholder Capacity

Section 301 prescribes the tax treatment of both dividend and nondividend distributions.[26] Section 301 does not apply to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in the shareholder's capacity as shareholder.[27] For example, payments made to a shareholder in the shareholder's capacity as an employee, creditor, or lessor of property to the corporation are not within the scope of §301.[28]

Comment: These limitations barely hint at the unfavorable treatment of equity capital in the income tax system. For instance, so long as interest payments are deductible and dividends are not, there will be a systemic bias against equity. Similarly, the system is prejudiced against equity when shareholders are also employees whose compensation is deductible (if "reasonable" under §162(a)). For closely held corporations, in fact, the system virtually invites shareholders, especially those who are also employees, to make contributions in forms other than equity. For a detailed discussion of these issues, see IV.F.1.h., below.

c. Property Must Be Distributed

To make a distribution a dividend, the corporation must distribute "property" to its shareholders. Section 317(a) defines "property" as "money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)."[29]

2. Potential Sources of Distribution

As previously noted, the treatment of a distribution as a dividend depends upon whether the distributing corporation has earnings and profits, either current or accumulated.[30] Earnings and profits may be considered a corporation's economic income available for distribution to shareholders. It is unfortunate, from the standpoint of certainty, that the concept of earnings and profits is a concept in search of a definition: it is nowhere defined in the Code.[31] The concept has survived, however, possibly because the phrase "earnings and profits" has a working definition even though it lacks a statutory definition. The usual starting point is taxable income, to and from which certain items are either added or subtracted.[32] For example, tax-exempt interest is added to taxable income and federal income taxes paid are subtracted from taxable income to determine earnings and profits.[33] The aim is to calculate a corporation's economic income available for distribution to shareholders.

Under §301(e), certain corporations are subject to reduced dividend opportunities by virtue of suspension of several statutory adjustments, in particular §312(k) and most of §312(n), which would otherwise increase earnings and profits. These rules apply to corporations owning 20% or more of a distributing corporation, because they can claim the dividends received deduction by virtue of their control over dividend policy. The result is to reduce the amount of earnings and profits available

[23] *See* IV.C., below, for a discussion of §305(a).

[24] §316(a)(1). Reg. §1.316-2(d) provides that distributions out of earnings and profits, accumulated before March 1, 1913, are not dividends.

[25] *See* §301(c)(2), §301(c)(3).

[26] A nondividend distribution occurs when a corporation has insufficient earnings and profits. *See* II.C.1.a., below.

[27] Reg. §1.301-1(d).

[28] However, if the payment is in reality a "constructive dividend" it may fall within the scope of §301. See IV.F., below.

[29] For a more detailed discussion on types of property, *see* IV.C., below. *See, e.g.*, PLR 200307009–PLR 200307062 (sale of water rights by shareholders of state mutual ditch company was not distribution of property to shareholders with respect to their stock). *See also* discussion of §305(b), below.

[30] §316. *See* II.B., below. *See also Juha v. Commissioner*, T.C. Memo 2012-68 (where taxpayers failed to prove that Canadian entities did not have sufficient current or accumulated earnings and profits to support dividend distributions and preponderance of evidence, including Form 1099-DIV and news releases, showed that distributions were taxable dividend distributions to taxpayers, amounts received from Canadian entities constituted dividend distributions).

[31] Staff of the Joint Comm. on Tax'n, "Tax Reform Proposals: Corporate Taxation," JCS-40-85, at 59 (1985):

> "There is no comprehensive statutory definition of the term 'earnings and profits,' nor does the term have a counterpart in the accounting or other areas. Indeed, the term may not lend itself to ready definition. The applicable statute and Treasury regulations merely describe the effects of specified transactions on a corporation's earnings and profits (sec. 312)."

[32] *See* Reg. §1.312-6. E&P may also be calculated based on retained earnings for financial accounting purposes, adjusted to more accurately reflect E&P. However, because the adjustments to E&P found in the Code, regulations, and other authorities assume adjustments are made to taxable income to account for various transactions, taxable income is the most logical starting point. For a detailed discussion of the computation of E&P, see 762 T.M., *Earning and Profits.*

[33] *See* §312 for the adjustments for dividends, as well as other adjustments.

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for distribution to 20%-or-more corporate shareholders, while increasing the amount available to others.

C. Treatment of Nondividend Distributions Under §301

1. General Rule

The corollary to the two-pronged earnings and profits limitation discussed above in II.B.1. is that a corporation with neither current nor accumulated earnings and profits may make distributions that are not treated as dividends. Under §301(c)(2), nondividend distributions, i.e., distributions that exceed corporate earnings and profits, are applied against the shareholder's basis and treated as a return of capital; any excess over basis is treated under §301(c)(3) as gain from a sale or exchange, i.e., capital gain.

2. Basis Reduction — Aggregation

Shareholders have contended that, in computing gain from a sale or exchange,[34] a shareholder is entitled to recover aggregate stock basis[35] before reporting a gain.[36] The position of the IRS is that the distribution is considered to have been made on a share-by-share basis.

Practice Point: This issue arises because shareholders may purchase various shares or blocks of stock at different times and for different prices. It also may arise if a shareholder has purchased one block of stock and was given or inherited another block of stock. It could lead to situations where a shareholder recognizes gain on some shares while having unrecovered basis on other shares. If the shareholder is allowed to recover the aggregate stock basis before reporting gain on the distribution, the shareholder can defer recognition of income.

In *Johnson v. United States*,[37] the taxpayers acquired 52% of the stock of a corporation in 1949 at a cost of $1,040. In 1954, the taxpayers acquired the remaining 48% of the stock of the corporation at a cost of $144,500. In 1963, the taxpayers received a distribution of $169,000. The parties agreed that a portion of the distribution was a dividend.[38]

Taking an aggregate basis approach, the taxpayers argued that the remaining amount of the distribution should be treated as follows:

Amount realized	$155,435
§301(c)(2) Basis Reduction	(145,540)
§301(c)(3)(A) Gain	$9,895

In determining gain from the sale of property, the adjusted basis of the property is subtracted from the amount realized.[39] "Amount realized" is defined in §1001(b) as the sum of money received plus the fair market value of property received.[40]

The position of the IRS was as follows:

	1949 shares	1954 shares
Amount Realized	$80,826	$74,609
§301(c)(2) Basis Reduction	(1,040)	(74,609)
§301(c)(3)(A) Gain	$79,786	-0-

The Fourth Circuit held that: (1) §301 and §1012[41] precluded aggregation of the costs of the two lots of stock to reach an adjusted basis for tax purposes; and (2) because the basis of property is its cost, two separate costs could not be aggregated to provide basis.[42]

In *Kinch v. Commissioner*,[43] the taxpayer owned 50% of the preferred stock and 50% of the common stock of a corporation. A distribution was paid on each class of stock. The taxpayer's adjusted basis in the common stock was zero before the distribution. The taxpayer argued that the adjusted basis of the preferred stock should be reduced under §301(c)(2) by the amount by which the distribution on the common stock exceeded earnings and profits, before the taxpayer could be required to recognize gain under §301(c)(3)(A). The Tax Court held that because the amount in excess of earnings and profits related to the distribution on the common stock, the taxpayer could not reduce the adjusted basis of the preferred but had to recognize the gain attributable to the distribution on the common stock.

Practice Point: A controlling shareholder who owns more than one class of stock can avoid the problem in *Kinch* and defer income by causing the corporation to allocate portions of the distribution to maximize use of the existing stock basis. For example, assume the taxpayer owns Class A and Class B stock, the basis of which is $10,000 and $6,000, respectively. The taxpayer's corporation can distribute up to $16,000 (assuming the corporation has no earnings and profits) without triggering gain recognition, provided that $10,000 of the distribution is allocated to Class A and $6,000 to Class B. This planning opportunity generally is available, however, only to closely held corporations.

D. Allocation of Earnings and Profits to Distributions

1. Current Earnings and Profits

To determine what, if any, portion of a distribution by a corporation to its shareholders is a dividend, §316(a)(2) pro-

[34] *See* §301(c)(3)(A).

[35] Section 301(c)(2) allows a shareholder to recover stock basis before computing gain under §301(c)(3)(A).

[36] *See* Letter from NYSBA to Mark Mazur, Ass't Sec'y of the Treas. (Tax Policy) (February 6, 2015), available at www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2015/Tax_Section_Cover_Letter_1316.html.

[37] 435 F.2d 1257 (4th Cir. 1971).

[38] The earnings and profits for the tax year were sufficient to make $13,565 of the $169,000 distribution a dividend. Thus, $155,435 remained for allocation. *Johnson v. United States*, 435 F.2d at 1258.

[39] §1001(a).

[40] §1001(b).

[41] Section 1012 provides that, in general, the basis of property is the cost of the property.

[42] *See also Estate of Rosset v. Commissioner*, T.C. Memo 1954-241 (taxpayer conceded correctness of IRS's position); *Skinner v. Eaton*, 45 F.2d 568 (2d Cir. 1930) (bases of separately acquired blocks of stock could not be aggregated in computing gain or loss on such stock upon its sale); Zuckerman, *Aggregation of Bases Under §301(c)(2) and (3)*, 33 Tax Law. 937 (Spring 1980).

Proposed regulations issued in January 2009 would have followed the *Johnson* approach, but were withdrawn in 2019. Former Prop. Reg. §1.301-2(a), REG-143686-07, 74 Fed. Reg. 3509 (Jan. 16, 2009), *withdrawn*, 84 Fed. Reg. 11,686 (Mar. 28, 2019). The notice of withdrawal noted that the IRS will continue to apply the outcome of *Johnson* in determining the basis.

[43] 1 T.C.M. 147 (1942).

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vides that the earnings and profits for the year are to be computed as of the close of the tax year without diminution by reason of any distribution made during that year. Determining dividend treatment at the time of the distribution can, however, be a tricky task for a corporation if there is an accumulated deficit in earnings and profits and there is a mid-year distribution. A deficit in earnings and profits before a mid-year distribution is not a determining factor when assessing the taxability of the distribution as there is no closing of the books or cut off before the distribution is made to determine whether it will be taxed as a dividend to the shareholders. The measurement of current earnings and profits occurs at the end of the tax year, thus making it difficult for a corporation to know with certainty the taxability of the distribution at the time it was made to a shareholder.

Example: Corporation Y has a fiscal year end of January 31. Y has a deficit of $30,000 in earnings and profits on January 31, Year One. On March 31, Year Two, Y makes a distribution to its shareholders of $200. On January 31, Year Two, Y has earnings and profits for the tax year ending January 31, Year Two, of $200, all of which came into being after March 31, Year Two. The distribution to the shareholders on March 31, Year Two, is a taxable dividend of $200.[44]

Practice Point: If Y projected a deficit of at least $200 for its year ending January 31, Year Three, Y might wait until after January 31, Year Two to make the distribution. Assuming the deficit projection was correct, a distribution made in the year ending January 31, Year Three would be treated as a basis reduction to the shareholders.[45] The earnings and profits for the year ending January 31, Year Two would be absorbed by the deficit existing on January 31, Year Three. There would be no post-1913 accumulated earnings and profits to cause dividend treatment for the year ending January 31, Year Three.

If a corporation has no post-1913 accumulated earnings and profits, and no earnings and profits at the end of the tax year, a distribution made by a corporation to its shareholders is not a taxable dividend.

Example: Corporation Y is a calendar year corporation. On January 1, Year One, Y has no post-1913 accumulated earnings and profits. In the first six months of Year One, Y has earnings and profits of $10,000. In the last six months of Year One, Y has a deficit in earnings and profits of $20,000, leaving a deficit in earnings and profits on December 31, Year One of $10,000. On June 1, Year One, Y makes a distribution to its shareholders of $10,000. Although on June 1, Year One, Y has sufficient earnings and profits to require dividend treatment of the distribution to its shareholders, §316(a)(2) requires earnings and profits to be computed as of the close of the tax year. Accordingly, the distribution to the shareholders on June 1, Year One is treated as a return of capital.[46]

[44] §316(a)(2); Reg. §1.316-2(b).

[45] To the extent of basis, the shareholders would receive a return of capital pursuant to §301(c)(2). If the distribution exceeded basis, the shareholders would recognize gain pursuant to §301(c)(3)(A).

There is no need to determine the order of priority of various distributions made by a corporation with respect to its stock during a particular tax year so long as the aggregate amount of the year's distributions does not exceed the earnings and profits of the tax year. Even if an excess does exist, the order of priority of distribution has no relevance — at least as far as the IRS is concerned — in determining which distributions have their source in the earnings and profits of the tax year, because the regulations require the earnings and profits of the tax year to be apportioned to all distributions pro rata, whenever made during the year.[47]

Example: X, a calendar year corporation, has $50 of earnings and profits for its tax year. X distributes $40 on June 1 and $40 on July 1. The June 1 distribution is deemed to be out of earnings and profits of the tax year to the extent of $25 ($50/80 × $40) and the July 1 distribution is deemed to be out of earnings and profits of the tax year to the extent of $25 ($50/80 × $40).

The regulations apply the above-mentioned method of apportionment of the earnings and profits of the tax year whether the year's distributions consist of cash or property.[48] When property other than money is distributed, the "amount of the distribution" (and, thus, the amount to be allocated against earnings and profits), for both corporate and noncorporate distributees, is the property's fair market value.[49]

2. *Accumulated Earnings and Profits*

If distributions made by a corporation to its shareholders for its tax year exceed both earnings and profits of that year and post-1913 accumulated earnings and profits, the available earnings and profits must be allocated to the various distributions to ascertain the "dividend" component of each distribution. In general, where distributions made by a corporation to its shareholders exceed the corporation's earnings and profits for its current tax year, the distributions are treated as having been made pro rata out of those earnings and profits. The remainder of the distributions are treated as dividends to the extent of the post-1913 accumulated earnings and profits available on the date the distribution was made. If the accumulated earnings and profits cannot be determined with respect to a particular date of distribution, the accumulated earnings and profits must be prorated.[50]

Example: Z, a calendar year corporation, has post-1913 accumulated earnings and profits of $12,000 on December 31, Year One. On December 31, Year Two, Z has earnings and profits for the tax year of $10,000. Z has two shareholders and distributes $15,000 on March 1, Year Two,

[46] For additional examples, see Rev. Rul. 74-164.

[47] Reg. §1.316-2(b). *See also* FSA 200225014.

[48] Reg. §1.316-2(b), as amended by T.D. 9914, 85 Fed. Reg. 66,471 (Oct. 20, 2020) (removing the reference to distributions that "consist only of money"). The Treasury amended the regulations to eliminate the reference to solely for cash to remain consistent with the treatment in FSA 200225014 under the theory that all property is fungible.

[49] §301(b)(1). For further discussion of the amount of a distribution in kind, see V.A.

[50] Reg. §1.316-2(b).

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and $15,000 on October 1, Year Two. Pursuant to §316, 33.3% of each distribution is treated as paid out of current earnings and profits (determined by dividing total current earnings and profits by total distributions for the same year). The remainder is allocated to accumulated earnings and profits to the extent they were available on the date of distribution. Therefore, the distributions are treated as follows:

Date of Distribution	Allocation of Current Earnings and Profits	Allocation of Accumulated Post-1913 Earnings and Profits	Total Dividend Portion
Mar. 1, Year Two	$5,000	$10,000	$15,000
Oct. 1, Year Two	5,000	2,000	7,000

Example: Z has a fiscal year ending January 31. Z has accumulated post-1913 earnings and profits on January 31, Year One of $16,000. Z incurs an operating loss of $14,000 for its year ending January 31, Year Two. On October 31, Year One, Z made a distribution to its shareholders of $16,000. Pursuant to Reg. §1.316-2(b), if the loss can be fixed to a time before October 31, Year One, the available post-1913 accumulated earnings and profits are reduced to $2,000, and, thus, the dividend portion is $2,000 and the remaining $14,000 reduces stock basis and/or creates gain from the sale or exchange of property. However, if it is not possible to fix the portion of the year in which the loss occurred, the loss is prorated over the year. There is $5,500 of available accumulated post-1913 earnings and profits on the date of distribution, because nine months of the loss is allocated to the period before the distribution. Thus, 9/12ths of the $14,000 loss reduces the accumulated post-1913 earnings and profits on October 31, Year One, from $16,000 to $5,500, resulting in a taxable dividend of $5,500.

The IRS has ruled that a corporation cannot use this "actual tracing method" (i.e., reducing the accumulated earnings and profits from prior years by the actual amount of the current year deficit up to the date of the distribution) if (i) the corporation has a loss during the early part of the current year in an amount greater than the accumulated earnings and profits as of the beginning of the year and (ii) it experiences a reversal in fortune in the latter part of the current year so that it realizes a profit for the year as a whole. In Situation 1 in Rev. Rul. 74-164, the corporation (a) had accumulated earnings and profits as of the beginning of the year of $40,000, (b) had a loss for the period from January 1 through June 30 of $50,000, (c) made distributions of $15,000 to its shareholders on July 1, and (d) had earnings and profits for the entire year of $5,000. The IRS ruled that the entire distribution of $15,000 was a dividend ($5,000 from earnings and profits of the current year, and $10,000 from the earnings and profits accumulated in prior years). If the corporation in this situation were permitted to offset its accumulated earnings and profits that existed at the beginning of the year by the loss that occurred during the part of the year before the dividend was paid, it could assert that the distribution was only a dividend to the extent of the earnings and profits for the current year ($5,000) despite the fact that it had yearend accumulated earnings and profits in an amount greater than the distributions made during the year.[51]

3. *Allocation of Earnings and Profits Among Two or More Classes of Stock*

If total distributions made during a corporation's tax year for two or more classes of stock exceed the earnings and profits of the current tax year and accumulated post-1913 earnings and profits, the earnings and profits must be allocated among the classes of stock. As discussed above, earnings and profits of the current tax year are allocated to distributions on a pro rata basis, rather than on the basis of the actual earnings and profits available at the time of each distribution.[52] In the case of a corporation with more than one class of stock, however, the IRS takes the position that, rather than being prorated among the different classes of shareholders, the earnings and profits of the current tax year are treated as having been distributed to the shareholders in the order of their priority under the corporate charter.[53] Thus, if a corporation has two classes of stock and the corporate charter requires preferential dividend treatment for payments to one class of stockholders (e.g., preferred stockholders), the corporate charter must be respected. Accordingly, in determining whether a distribution is a dividend, the earnings and profits for the current tax year must be allocated first to the preferred class of stockholders, and only then to the junior stockholders. The IRS bases its position on case law recognizing the right of a preferred shareholder to a preference to the earnings of the corporation for each year.[54]

Example: Y is a calendar year corporation that has two classes of stock, common and preferred. The corporate charter provides that the preferred shareholders are entitled to a distribution of $1,000 each year before a distribution can be made to the common shareholders. Y has no accumulated earnings and profits on January 1, Year One. For the year ending December 31, Year One, Y has earnings and profits of $1,500. On June 1, Year One, Y makes a distribution of $1,000 to its preferred shareholders and a distribution of $1,000 to its common shareholders. The distribution to the preferred shareholders is a dividend in its entirety, and the distribution to the common shareholders is a dividend to the extent of the remaining earnings and profits of $500.

Example: The facts are the same as in the preceding example, except that instead of having only one class of common, Y has two classes, Class A Common and Class B

[51] *See also* GCM 35307 (Apr. 16, 1973); FSA 200225014; Andrew M. Eisenberg, *Determination of Accumulated Earnings and Profits: Is Actual Tracing Method a Viable Approach?* 38 Tax Mgmt. Memo. Spec. Ed. 1997-1: Corp. Tax and Bus. Plan. Rev. S-13 (Jan. 20, 1997).

[52] Reg. §1.316-2(b).

[53] Rev. Rul. 69-440.

[54] *Barclay v. Wabash Ry. Co.*, 30 F.2d 260 (2d Cir. 1929).

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Common. There are no dividend preferences provided for in the corporate charter as between the Class A common stock and the Class B common stock. Thus, the distribution to the preferred shareholders is a dividend in its entirety, and the remaining $500 of earnings and profits is allocated to the Class A and Class B common stock pro rata.

Distributions made to holders of a senior class of stock in satisfaction of its dividend rights must, as a matter of law, precede the dividend rights of a junior class of stock. The same rule of priority applies when the amount of distributions made during the year with respect to the senior class of stock exceeds the earnings and profits of the tax year; all the current earnings and profits are allocated to the senior class of stock. Similarly, under the chronological approach for allocating accumulated earnings and profits, if distributions of at least the current and accumulated earnings and profits are made with respect to the senior class of stock before any distributions are made with respect to the junior class of stock, no earnings and profits are allocated to the latter.

Example: X is a calendar year corporation that has two classes of stock, common and preferred. X has accumulated earnings and profits of $10,000 on January 1, Year One, and $2,000 of current earnings and profits for its tax year ending December 31, Year One. On June 1, Year One, X distributes $14,000 to its preferred shareholders, and, on July 1, Year One, distributes $7,000 to its common shareholders. On these facts, $2,000 of the $14,000 distributed to the preferred shareholders is made out of current earnings and profits, and the remaining $12,000 is made out of accumulated earnings and profits to the extent of $10,000. No part of the $7,000 distributed with respect to the common stock has its source in earnings and profits.

If the preferred dividends paid during a tax year exceed current earnings but not post-1913 accumulated earnings and profits, the rule is not as clear. One approach is to treat all distributions paid on stock having a preference under the corporate charter during the entire tax year as having priority with respect to the allocation of post-1913 accumulated earnings and profits as well as earnings and profits for the current tax year.

Another approach is to allocate current earnings and profits to stock having a preference under the corporate charter, while allocating accumulated earnings and profits chronologically, giving distributions on preferred stock priority over distributions on junior stock made on the same date.

The latter approach is consistent with: (1) apportioning current earnings and profits, in accordance with Reg. §1.316-2(b); (2) recognizing the priority of the preferred distributions in regard to current earnings and profits, as required by Rev. Rul. 69-440; and (3) the rule that accumulated earnings are measured as of the date of each distribution (i.e., chronologically), as indicated by Rev. Rul. 62-131 and Rev. Rul. 74-164.

4. *Allocation of Earnings and Profits Between Redemption Distributions and Ordinary Distributions on Stock*

Ordinary distributions on stock take priority over redemption distributions as to the allocation of earnings and profits of the tax year.[55] However, if, during a tax year, the ordinary distributions on stock plus the redemption distributions exceed the earnings and profits for that year, post-1913 accumulated earnings and profits are allocated chronologically.[56]

Example:[57] X is a calendar year corporation that has no current earnings and profits. As of January 1, X has post-1913 accumulated earnings and profits of $10,000. On June 1, X redeems 20% of its outstanding common stock. On January 1 and July 1, X makes ordinary distributions of $7,000 and $3,000, respectively, to its shareholders. The allocation of earnings and profits is as follows:

Distribution	Current Earnings and Profits	Earnings and Profits	Accumulated Dividend Total
Jan. 1	-0-	$7,000	$7,000
June 1	-0-	600	600
July 1	-0-	2,400	2,400
	-0-	$10,000	$10,000

The $600 charge to accumulated earnings and profits for the June 1 redemption represents the pro rata portion of total earnings and profits attributable to the shares redeemed (20% × $3,000 (accumulated earnings and profits remaining after the $7,000 charge for the January 1 distribution)).[58]

The amount of any redemption payments chargeable to earnings and profits that exceeds the total amount of earnings and profits for the current tax year and post-1913 accumulated earnings and profits cannot be used to reduce earnings and profits accumulated in subsequent years.[59]

E. *Treatment of Distributions Made by S Corporations*

1. *In General*

Section 1368 governs the treatment of distributions of property made by an S corporation with respect to its stock that, but for §1368, would be treated in the manner provided for in §301.[60] The treatment of a distribution of property made by an S corporation depends on whether or not the S corporation has post-1913 accumulated earnings and profits. Although, generally, an S corporation does not have earnings and profits for tax

[55] *Baker v. United States*, 308 F. Supp. 1129 (D. Neb. 1970), *aff'd*, 460 F.2d 827 (8th Cir. 1972); *Anderson v. Commissioner*, 67 T.C. 522 (1976), *aff'd*, 583 F.2d 953 (7th Cir. 1978); Rev. Rul. 74-338; Rev. Rul. 74-339.

[56] Reg. §1.316-2(b); Rev. Rul. 74-338.

[57] Rev. Rul. 74-338.

[58] §312(n)(7). For a discussion of the amount of a redemption distribution chargeable to earnings and profits, see 762 T.M., *Earnings and Profits*.

[59] *Estate of Uris v. Commissioner*, 68 T.C. 448 (1977), *aff'd*, 605 F.2d 1258 (2d Cir. 1979).

[60] §1368(a).

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years beginning after 1982,[61] it may still have post-1913 accumulated earnings and profits from:

(1) previous non-S corporation years of the corporation;[62]

(2) for tax years beginning before January 1, 1997, earnings and profits from S corporation years beginning before 1983;[63] and

(3) an acquired corporation.[64]

For a detailed discussion of the treatment of S corporations, see 731 T.M., *S Corporations: Corporate Tax Issues.*

2. Distributions by S Corporations with No Post-1913 Accumulated Earnings and Profits

A distribution of property by an S corporation with no post-1913 accumulated earnings and profits to its shareholder is not includible in the gross income of the shareholder to the extent the distribution does not exceed the adjusted basis of the shareholder's stock.[65] A downward adjustment to the shareholder's adjusted basis in the shareholder's stock is made in the amount of the distribution, but not below zero. The amount of the distribution that exceeds the shareholder's adjusted basis in his stock is treated as gain from the sale or exchange of property.[66]

Section 1368(d) provides that, in application of this basis adjustment rule, the basis adjustments required by §1367[67] are made before the shareholder's adjusted basis is reduced by the amount of the distributions.

> *Example:* X owns all of the stock in S, a calendar year S corporation with no post-1913 accumulated earnings and profits. On January 1, Year One, X's adjusted basis in X's stock is $10,000. During the year, S makes distributions to X of $35,000. On December 31, Year One, S's taxable income is $20,000. Before taking into account the distribution on X's stock, pursuant to §1367, X's basis in X's stock is increased to $30,000.[68] As a result of the distribution, X's stock basis is reduced to zero,[69] and X must recognize $5,000 in gain from the sale or exchange of property.[70]

Regulations under §1367 and §1368 discuss the manner in which adjustments are made to the basis of S corporation stock and the treatment of distributions by an S corporation to its shareholders. Under Reg. §1.1367-1(b)(2), adjustments to the basis of a shareholder's S corporation stock is determined on a per-share, per-day basis. If the amount attributable to a share exceeds its basis, the excess reduces (but not below zero) the remaining bases of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of those shares.[71] In this case, S corporations are similar to C corporations, which also must maintain separate bases for different blocks of stock.[72] Partners and partnerships, on the other hand, use an aggregate basis in calculating stock basis.[73]

The regulations apply to tax years of the corporation beginning on or after January 1, 1994. The treatment of distrib-

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[61] §1371(c). Under the law in effect before the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, an S corporation could have earnings and profits, even in S corporation years, because subchapter C provided that various items that were deductible or excludible in computing taxable income were not deductible in computing earnings and profits. *See* §312. These items include tax-exempt income, the excess of percentage depletion over cost depletion, and the excess of accelerated depreciation over straight line depreciation. The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §1311, provides that, if a corporation is an S corporation for its first tax year beginning after 1995, the accumulated earnings and profits of the corporation as of the beginning of that year are reduced by the accumulated earnings and profits (if any) accumulated in any tax year beginning before 1983 for which the corporation was an S corporation. This reduction ensures that such a corporation's accumulated E&P is solely attributable to tax years for which an S election was not in effect. *See* H.R. Rep. No. 104-280(II), at 506 (1995). The Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, §8235, extends this treatment to any corporation which was not an S corporation for its first tax year beginning after 1996. Any reduction in the accumulated earnings and profits of the corporation occurs as of the beginning of the first tax year beginning after May 25, 2007. *See* Staff of the Joint Comm. on Tax'n, "Technical Explanation of the Small Business and Work Opportunity Tax Act of 2007," JCX-29-07, at 25 (2007).

[62] An S corporation may have earnings and profits remaining from years in which it was a C corporation. See §312 for the computation of earnings and profits. Once a corporation converts to S status, the amount of earnings and profits that it generated as a C corporation is frozen; it cannot retroactively revise this amount even if the amount was originally based on an estimate and more accurate information becomes available in subsequent years. In *Broadaway v. Commissioner*, 111 F.3d 593 (8th Cir. 1997), for example, a C corporation was engaged in the construction business and calculated its income using the completed contract method of accounting. Section 312(n)(6) required, however, that the corporation compute its earnings and profits using the percentage of completion method, which incorporates estimates of the total costs of long-term contracts. The corporation elected to be taxed as an S corporation effective following the close of its tax year ending in 1988. In 1989, the corporation made a distribution to its shareholders. The Eighth Circuit held that, for purposes of measuring the amount of the distribution that would be treated as a taxable dividend, the corporation's earnings and profits for its last tax year as a C corporation must be computed on the basis of the year-end estimates of the total costs of the long-term contracts; the estimates could not be revised retroactively to reflect actual costs, and earnings and profits could not be adjusted for subsequent tax years to which the S election applied. The court explained that if the corporation had not made the S election, the percentage of completion method normally would correct itself in later years for any erroneous estimates made in prior years. However, the court stated, under the rule prohibiting retroactive recomputation, the shareholders could not take advantage of this correction mechanism to reduce their dividend income for 1989 because making the S election had the consequence of freezing the corporation's earnings and profits.

[63] For S corporation years beginning after 1983, generally no adjustment is made to the earnings and profits of an S corporation. *See* §1371(c). For years beginning before 1983, an S corporation could have had an increase in accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. However, the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §1311, provides that if a corporation is an S corporation for its first tax year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of that year are reduced by the accumulated earnings and profits (if any) accumulated in any tax year beginning before 1983 for which the corporation was an S corporation.

[64] §1371(c)(2).

[65] §1368(b)(1).

[66] §1368(b)(2).

[67] Section 1367(a) requires certain adjustments to be made to a shareholder's basis in the shareholder's stock. Among them are increases to basis for the shareholder's pro rata share of the income of the corporation if separate treatment of an income item would affect the tax liability of any shareholder.

[68] §1367(a)(1).

[69] §1368(b)(1).

[70] §1368(b)(2).

[71] Reg. §1.1367-1(c)(3).

[72] For further discussion, see II.C.3.b., above.

[73] *See generally* §705.

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utions in prior years must be determined in a reasonable manner.[74]

For a detailed discussion of S corporation stock basis adjustments and the regulations, see 731 T.M., *S Corporations: Corporate Tax Issues.*

3. *Distributions by an S Corporation with Post-1913 Accumulated Earnings and Profits*

To the extent of the accumulated adjustments account,[75] distributions of property by an S corporation with post-1913 accumulated earnings and profits are treated in the same manner as distributions from an S corporation with no post-1913 accumulated earnings and profits.[76] Distributions to the extent of the accumulated adjustments account that do not exceed a shareholder's basis in the shareholder's stock are not included in gross income.[77] Distributions to the extent of the accumulated adjustments account that exceed a shareholder's stock basis are treated as gain from the sale or exchange of property.[78]

Any amounts distributed in excess of the accumulated adjustments account are treated as a dividend to the extent of the post-1913 accumulated earnings and profits of the S corporation.[79] Generally, if distributions to shareholders during the tax year exceed the accumulated adjustments account, the accumulated adjustments account is allocated pro rata to all distributions during the year.[80] Amounts distributed and remaining after all post-1913 accumulated earnings and profits have been distributed are treated as returns of capital that reduce stock basis (but not below zero); the excess, if any, is treated as gain from the sale or exchange of property.[81] Section 1368 also provides that an S corporation may elect not to make distributions out of its accumulated adjustments account, provided all affected shareholders consent.[82] The election is made annually.[83]

Comment: This election is generally made when the S corporation has post-1913 accumulated earnings and profits, to avoid the tax on passive investment income[84] and to prevent the termination of S status due to excessive passive investment income.[85]

[74] Reg. §1.1367-3, §1.1368-4.

[75] Section 1368(e) defines "accumulated adjustments account" (AAA) by prescribing numerous adjustments to S corporation income that has been taxed but not yet distributed. Only S corporations with earnings and profits must keep an AAA. For more detailed information regarding AAAs, see 730 T.M., *S Corporations: Formation and Termination*, and 731 T.M., *S Corporations: Corporate Tax Issues.*

[76] §1368(c)(1).

[77] §1368(c)(1), §1368(b)(1).

[78] §1368(c)(1), §1368(b)(2).

[79] §1368(c)(2).

[80] §1368(c) (flush language).

[81] §1368(c)(3), §1368(b).

[82] §1368(e)(3)(A). Section 1368(e)(3)(B) defines "affected shareholder" as any shareholder to whom a distribution is made during the tax year for which the election is made.

[83] §1368(e)(3)(A).

[84] Section 1375(a) imposes a tax at the highest corporate rate on an S corporation that has subchapter C earnings and profits at the close of a tax year, provided that more than 25% of that year's gross receipts are from passive investment income.

[85] Section 1362(d)(3) provides that an S election terminates whenever the corporation has accumulated earnings and profits at the close of each of three consecutive tax years and has gross receipts for each such year more than 25% of which are passive investment income.

In addition, if the corporation was an S corporation for its last tax year beginning before 1983 and it has previously undistributed taxable income, the corporation can make a cash distribution with amounts distributed in excess of the accumulated adjustments account; these amounts are treated as first coming out of previously undistributed taxable income and, therefore, are not taxable to the shareholders; the remainder is treated as coming out of post-1913 accumulated earnings and profits.[86]

F. Distributions Made by Foreign Corporations

Section 1248 treats gain arising from the sale or exchange of stock in a controlled foreign corporation as a dividend to the extent of a pro rata share of the earnings and profits of the controlled foreign corporation accumulated after 1962.[87] Section 1248 applies only if the United States person owns (within the meaning of §958(a)), or is considered as owning (by applying the rules of ownership of §958(b)), 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation at any time during the five-year period ending on the date of the sale or exchange when such foreign corporation was a controlled foreign corporation.[88] The relevance of §1248 as it relates to dividends has been tied to the changes in the dividends received deduction, specifically the 100% dividends received deduction for the foreign source portion of dividends under §245A. Section 1248(j) provides: In the case of the sale or exchange by a domestic corporation of stock in a foreign corporation held for 1 year or more, any amount received by the domestic corporation which is treated as a dividend by reason of this section shall be treated as a dividend for purposes of applying §245A.[89]

See 6280 T.M., *CFCs — Sections 959–965 and 1248* (Foreign Income Series), for discussion of the treatment as dividends of gains from the sale of stock in controlled foreign corporations.

G. Distributions that Are Not Dividends for State Law Purposes

A distribution of cash or property that is a dividend for tax purposes is not necessarily a dividend under applicable state law. State law often limits the distributions that can be dividends: a corporation generally cannot, under state law, declare a dividend out of capital stock, nor can it declare a dividend when it is insolvent or would be made insolvent by the declaration of a dividend. If a distribution is not a dividend under ap-

[86] §1379(c); former §1375(d), §1375(f). Thus, the remainder is treated as a dividend. Before the Subchapter S Revision Act of 1982, a shareholder could include a constructive dividend in income under former §1373(b), thus reducing accumulated earnings and profits and the shareholder's basis. The effect was the same as if the amount had been distributed to the shareholder and returned to the corporation as a capital contribution. Former §1375(d)(1) allowed the S corporation to distribute previously undistributed taxable income to shareholders without dividend treatment.

[87] §1248(a)(1). Reg. §1.1411-1(d)(3)(ii) provides that amounts treated as dividends under §1248(a) are included in net investment income for purposes of the §1411 net investment income tax (NIIT), except as provided by Reg. §1.1411-10. *See* T.D. 9644, 78 Fed. Reg. 72,393 (Dec. 2, 2013). For a detailed discussion of the NIIT, see 511 T.M., *Section 1411 — Net Investment Income Tax.*

[88] §1248(a)(2).

[89] See IV.D., below, for a discussion of §245A. For a detailed discussion of §245A, see 6130 T.M., *Participation Exemption Regime Under Section 245A.*

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plicable state law, but comes within the definition of a dividend in §316(a), the distribution ordinarily is taxable as a dividend.[90]

In *United States v. Lesoine*,[91] a corporation made two distributions to its shareholders in 1942. One distribution was paid in cash and the other distribution was credited to the loans receivable accounts of the shareholders on the books of the corporation. In 1943, it was determined that there had been insufficient surplus for the payment of the first distribution under state law and no surplus for the payment of the second distribution under state law. The corporation recalled the distributions. The shareholders who repaid the distributions argued that the distributions should not be taxable to them as they were not entitled to receive the distributions under state law. The Ninth Circuit held that the distributions were plainly dividends within the meaning of former §115(a)[92] (even though the corporation had no book surplus at the time of the distributions) because the corporation had earnings and profits available and the distributions, thus, came within the tax definition of "dividend." Additionally, the court stated, because the shareholders received the distributions under a claim of right,[93] the distributions were taxable to the shareholders despite the fact that the payments violated state law.

In *Knight Newspapers, Inc. v. Commissioner*,[94] distributions were made by a subsidiary on its common stock to its parent. However, because the distributions on the common stock violated the rights of the subsidiary's preferred shareholders, in the following year the subsidiary rescinded the distributions. The Sixth Circuit held that the parent received the distributions under a constructive trust and, therefore, the distributions were not taxable to the parent despite the existence of earnings and profits.

Comment: The decision appears to have arisen from a desire on the part of the Sixth Circuit not to subject the parent corporation to a large personal holding corporation surtax on undistributed earnings that could not have been recouped by taking a deduction for the repayment in the year following the distribution.[95] On similar facts, the Second Circuit in *St. Regis Paper Co. v. Higgins*[96] held that, although the shareholder may have put itself in a position in which it could have been liable as a constructive trustee, the shareholder received and held the distributions as its own under a claim of right, thus rendering the distributions income to the shareholder in the year in which they were received.

If a distribution is paid in violation of either state law or the corporate charter, the distribution is dividend income to the person receiving the distribution in the year of receipt if sufficient earnings and profits are available, even if the distribution is repaid in a subsequent year.

H. High-Yield Discount Obligations

Under §163(e)(5), certain debt instruments (DIs) have an equity element sufficiently strong to warrant their classification, at least in part, as preferred stock. These DIs, known as applicable high yield discount obligations (AHYDOs), are thus treated as part stock and part debt. The portion of the interest payment on an AHYDO that exceeds a certain threshold is treated as a payment of a dividend rather than of interest, except that this type of dividend's effect on a corporation's earnings and profits differs from that of an ordinary dividend.

An AHYDO is a DI the maturity date of which is more than five years from the issue date, that has "significant" original issue discount (OID), and the yield to maturity of which exceeds by at least five percentage points the applicable federal rate (AFR) that was in effect during the month in which the DI was issued.[97] A DI has "significant" OID if, at the close of any accrual period (usually semi-annual in the case of a corporate instrument) after the instrument's fifth anniversary, the aggregate amount includible in the holder's gross income exceeds the sum of (i) the aggregate amount of interest payable before the close of that accrual period plus (ii) the DI's issue price multiplied by its yield to maturity (the interest accrued for its first year).[98] This OID is then bifurcated into qualified OID and disqualified OID, which may depend on the amount of the AHYDO's "disqualified yield."[99] If the AHYDO has a yield exceeding the AFR plus six percentage points, any excess is "disqualified yield."[100] The disqualified portion of the OID is the lesser of: (1) the instrument's OID; and (2) the portion of the "total return" on the instrument that bears the same ratio to the instrument's "total return" as the disqualified yield bears to the instrument's yield to maturity.[101]

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[90] *Jaques v. Commissioner*, 935 F.2d 104 (6th Cir. 1991) (recharacterizing "loans" as constructive dividends even though state law prohibited corporation from paying dividends because it had negative retained earnings); *Wentworth v. Commissioner*, 510 F.2d 883 (6th Cir. 1975) (taxable income from stock redemption even though redemption might have violated state law); *Estate of Crellin v. Commissioner*, 203 F.2d 812 (9th Cir. 1953) (no deduction for voluntary repayment of dividends paid under erroneous belief that personal holding company liability had been incurred); *Lundeen v. Commissioner*, 33 T.C. 19 (1959) (taxability of corporate distributions is determined under Code).

[91] 203 F.2d 123 (9th Cir. 1953).

[92] Predecessor to §316(a).

[93] The claim of right doctrine provides that a taxpayer, receiving income without restriction as to its disposition and treating the income as belonging to the taxpayer, must report the income for federal income tax purposes in the tax year of receipt even though the taxpayer may claim not to be entitled to retain the income and, in fact, may be adjudged liable to restore it. The claim of right doctrine had its origin in *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417 (1932).

[94] 143 F.2d 1007 (6th Cir. 1944).

[95] The argument that a constructive trust creates a restriction on use, thus precluding the taxpayer from receiving funds under a claim of right, was rejected by the Supreme Court in *Healy v. Commissioner*, 345 U.S. 278 (1953). In *Haberkorn v. United States*, 173 F.2d 587 (6th Cir. 1949), the Sixth Circuit limited *Knight Newspapers* to its facts.

[96] 157 F.2d 884 (2d Cir. 1946).

[97] §163(i)(1). The Secretary is granted authority to use a rate that is higher than the applicable federal rate for purposes of applying §163(e)(5) for obligations issued after December 31, 2009, if the Secretary determines that such higher rate is appropriate in light of distressed conditions in the debt capital markets. §163(i)(1) (flush language), as amended by the American Recovery and Reinvestment Act of 2009 (2009 ARRA), Pub. L. No. 111-5, Div. B, §1232(b). Of note, many debt instruments that have the characteristics of an AYHDO instrument may have an AYHDO catch-up clause that requires borrowers to pay in cash an amount that is necessary to ensure that the DI shall not be considered an "applicable high yield discount obligation" before the fifth year anniversary of the issuance of the DI. The enforceability of the catch-up clause may recharacterize the instrument as AYHDO at the date of issuance regardless of whether the instrument is significantly modified after issuance.

[98] §163(i)(2).

[99] §163(e)(5).

[100] §163(e)(5)(C)(ii).

[101] §163(e)(5)(C)(i). The instrument's "total return" is the amount that would be OID if interest based on a fixed rate and payable at fixed intervals of one year or less during the term of the obligation were included in the stated redemption price at maturity. §163(e)(5)(C)(ii).

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The disqualified portion of OID is treated as a dividend to the extent actually paid by the corporation, both by the corporation that issued the AHYDO and by the AHYDO's holder. Therefore, the dividends received deduction may be available to corporate holders of AHYDOs.[102] Furthermore, although qualified OID may not be deducted until paid (in contrast to OID on ordinary DIs, which may be deducted as it is deemed to accrue),[103] it reduces earnings and profits in the same manner as OID on ordinary DIs.[104] The deemed dividend portion of OID (disqualified OID) also reduces earnings and profits. However, for purposes of determining the extent to which disqualified OID is treated as a dividend equivalent for any year, earnings and profits are not reduced by the disqualified OID for that year.[105]

Practice Point: Of note, the characterization of the disqualified portion may require a reporting obligation by the issuer to the holder of a Form 1099-DIV.

> *Example:* A corporation accrues $1,000 of interest with respect to an AHYDO for a tax year; $800 of this amount is treated as interest for which a deduction is allowed when paid and $200 is the disqualified portion. None of the interest is paid during the year. The corporation has $1,100 of earnings and profits before the accrued interest on the AHYDO is taken into account. Thus, the issuing corporation has earnings and profits of $100 for purposes other than determining the character of the portion of the yield that is treated as a distribution with respect to stock, and it has $300 of earnings and profits for purposes of determining the character of the portion of the yield that is treated as a distribution with respect to stock. However, the $300 of earnings and profits is reduced by $200 for purposes of determining earnings and profits in subsequent years.[106]

Under certain conditions, the rules of §163(e)(5) did not apply to AHYDOs issued during the period beginning on September 1, 2008, and ending on December 31, 2009.[107] Treasury is authorized in §163(e)(5)(F)(iii) to extend the suspension if it determines that extension is appropriate in light of distressed conditions in the debt capital markets. Pursuant to this authority, suspension of the AHYDO rules was extended to December 31, 2010, for any AHYDO that is a qualified obligation.[108]

A detailed analysis of the AHYDO provisions is contained in 181 T.M., *Time Value of Money — Holders of Debt Instruments*, and 182 T.M., *Time Value of Money — Issuers of Debt Instruments.*

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[102] §163(e)(5)(B). The DRD for corporate shareholders changed under the TCJA. For further discussion, see VI.B., below.

[103] §163(e)(5)(A)(ii).

[104] §163(e)(5)(E).

[105] §163(e)(5)(E). *See also* H.R. Rep. No. 101-386, at 555 *Ex.* 3 (1989) (Conf. Rep.). Of note, the tax treatment of any prepayment penalties associated with a DI with AYHDO is an open question as to whether it is treated as a dividend or deductible interest, which may be subject to limitations under §163(j).

[106] This example is drawn from H.R. Rep. No. 101-386, at 555 *Ex.* 3 (1989) (Conf. Rep.).

[107] §163(e)(5)(F).

[108] Notice 2010-11, obsoleted by Notice 2025-36.

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III. Accounting for Dividends

A. *In General*

The timing of when a distribution is taken into account is important:

> (1) in fixing the time when earnings and profits must be measured to determine if the distribution is a dividend as defined in §316;[109] and
>
> (2) in determining the year in which the dividend must be reported in the income of the recipient.[110]

The year as of which the taxable status of a distribution is determined may differ from the year in which the distribution is included in the recipient's income.[111]

B. *Determining Tax Status of Distribution*

1. *Alternatives*

No statutory rule prescribes the time for taking a corporate distribution into account for purposes of determining the amount of available earnings and profits. The IRS and the courts have not adhered to a uniform rule. Four events have been proposed as the appropriate point: (1) the date of actual or constructive distribution (i.e., the date on which the corporation physically makes payment or makes the payment available to the shareholder); (2) the date on which the corporation declares the distribution; (3) the record date (i.e., the date by which the stock must be held in order for the holder to be entitled to receive the distribution); and (4) the date of actual or constructive receipt of the distribution by a particular shareholder.

2. *Generally Applied Rule — Date of Actual or Constructive Distribution*

The IRS takes the position that the taxable status of a distribution and its effect on earnings and profits are determined by reference to the corporation's earnings and profits for the tax year of actual or constructive payment if the distribution is out of earnings and profits of the current tax year; if the distribution is out of post-1913 accumulated earnings and profits, then the taxable status of a distribution and its effect on earnings and profits are determined by reference to the earnings and profits on the date of actual or constructive payment.[112]

The only significant judicial support for this position is the Supreme Court's decision in *Mason v. Routzahn*,[113] in which the Court held that dividends declared in 1916 but paid in 1917 were subject to the Revenue Act of 1917. However, that decision determined only that the statutory requirement for inclusion of the dividend in income for the year of receipt evidenced congressional intent that 1917 law should control the tax treatment to the recipient of a dividend paid and received in 1917, and that the income was taxable at 1917 rates.

3. *Alternative Rules*

a. *Declaration Date*

In *Commissioner v. Goldwyn*,[114] the Ninth Circuit, contrary to the IRS's position, held that the declaration date was the appropriate time for determining a distribution's tax status. In *Goldwyn*, the resolution of the taxable status of the distribution depended upon the nature of a transaction occurring years earlier. The corporation declared a distribution in 1930 but did not make payment until 1933. When the distribution was declared, the corporation segregated a portion of its earnings and profits and set aside an amount from its surplus for payment. The issue was whether the corporation's post-1913 accumulated earnings and profits and its current earnings and profits were reduced by the declaration of the distribution in 1930 or by the payment of the distribution in 1933. The Ninth Circuit held that the distribution reduced post-1913 accumulated earnings and profits and current earnings and profits at the time of its declaration. The court determined that the declaration created a debtor-creditor relationship between the corporation and its shareholders, which, in turn, created a legally enforceable obligation.[115]

Cases decided after *Goldwyn* appear to question its viability and limit the case to its facts. In *Fehrs Fin. Co. v. Commissioner*,[116] for example, stock was redeemed[117] in return for annuity payments. In the year of redemption, no annuity payments were made and no gain was required to be recognized by the shareholder. The taxpayer argued that the tax character of the annuity payments distributed in later years should be governed by the corporation's earnings and profits in the year of redemption and not in the year in which the payments were made and received.

The Tax Court distinguished *Goldwyn*, noting that in that case the corporation segregated a portion of its earnings and profits and actually set aside an amount of its surplus, thus creating a fixed liability to its shareholder. In *Fehrs*, the corporation had no earnings and profits at the time of the redemption and did not set aside any specific sum from any source to satisfy the obligation. The Tax Court stated:

> [I]t does not follow that if a corporation, when it lacks earnings and profits, becomes obliged to make distributions to shareholders … such distributions will be treated as if made when the corporation had no earnings and profits. The purposes of §301 and §316 would surely be violated if we were to hold that distributions made by a corporation to its sharehold-

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[109] §316(a).

[110] §61(a)(7), §301(c).

[111] Reg. §1.301-1(c); Rev. Rul. 65-23, *amplifying* Rev. Rul. 64-290.

[112] Rev. Rul. 62-131. *See* Reg. §1.316-2 (sources of distributions).

[113] 275 U.S. 175 (1927).

[114] 175 F.2d 641 (9th Cir. 1949).

[115] *Cf. Pittway Corp. v. United States*, 88 F.3d 501 (7th Cir. 1996) (corporate distribution authorized by board of directors before June 14, 1984, was deemed "declared" upon approval of shareholders after that date, so corporation was taxable on distribution of appreciated property; distribution, which was governed by law of France, required shareholder approval before board of directors' action was legally binding).

[116] 58 T.C. 174 (1972). *See also Stephens v. Commissioner*, 60 T.C. 1004 (1973).

[117] The stock was redeemed in a §304(a)(1) redemption that did not qualify as a §302 exchange. Therefore, pursuant to §302(d), the distribution was treated as a distribution of property to which §301 applied. For a discussion of §304, *see* 768 T.M., *Stock Sales Subject to Section 304.*

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> ers out of earnings and profits could be treated as recoveries of basis or capital gains to the shareholders simply because the payments were made pursuant to the terms of an agreement entered into by the corporation in an earlier year when it had no earnings and profits.[118]

The Tax Court held that the taxability of the annuity payments depended on the earnings and profits existing in the later years.

b. Record Date

There is no authority for use of the record date as the date on which distribution occurs other than for corporations filing consolidated returns, although the IRS argued unsuccessfully for such an approach in *Commissioner v. Am. Light & Traction Co.*[119]

c. Date of Receipt

Although Reg. §1.301-1(c) sets the date of receipt as the proper time for including the distribution in the shareholder's gross income, there is no direct authority supporting this date as the date that determines the distribution's tax status.[120] For example, dividend checks that are mailed on December 31 are generally reported as having been paid in the following calendar year if no shareholder could have received his dividend check before January.

C. Including Distribution in Gross Income of Distributee

1. Generally

Since 1921, the regulations have consistently stated that a corporate distribution is includible in the shareholder's income when it is "unqualifiedly made subject to" the shareholder's demand.[121] This position has been accepted by the courts in situations involving both cash and accrual method shareholders. For example, in *Commissioner v. Am. Light & Traction Co.*,[122] the court approved of the rule including distributions in gross income in the year received regardless of the shareholder's method of accounting. This rule, the court stated, maintains uniformity of tax consequences to the various shareholders. The court viewed a single rule of inclusion of distributions in the year of receipt as precluding the possibility of (i) taxation of an accrual method shareholder based on the extent of earnings and profits on hand for the year of the declaration or record date and (ii) taxation of a cash method shareholder based on the extent of earnings and profits on hand for the later year of actual receipt.

The situation often arises in which a dividend is payable on or before December 31, but dividend checks are not mailed until December 31 and are not received by the shareholders until the following year. In *Avery v. Commissioner*,[123] the shareholder was also the president of a corporation that, in November, declared a dividend payable on or before December 31. The dividend checks were mailed on December 31 to all shareholders except those who were officers and employees, including the taxpayer. Checks for the officers and employees were held in the treasurer's office until the first business day of January and then distributed through office mail. The Supreme Court held that because it was the corporation's practice to mail dividends payable on or before December 31 to officers and employees on the first business day in January, the distributions were includible in income in the year received. The Court pointed out that the evidence did not show that the taxpayer could have obtained payment on December 31 or that there was an unrestricted right to obtain payment other than the way in which it was distributed. Therefore, the dividends were not unqualifiedly made subject to the taxpayer's demand in December.[124]

2. Constructive Receipt

Whether a distribution of cash or other property is unqualifiedly made subject to a shareholder's demand requires a determination of whether:

(1) the shareholder has an unrestricted, legal right to demand payment of the distribution at any time;

(2) there is an agreement among the shareholders to defer payment; and

(3) the corporation has the ability to fulfill the distribution.[125]

This three-part test is the essence of the doctrine of constructive receipt. The doctrine of constructive receipt applies if a shareholder fails to appropriate a distribution that is otherwise available to the shareholder.[126] The doctrine requires the shareholder to include these amounts in gross income at the time at which the shareholder could have received the distribution. The determination of whether a distribution is unqualifiedly made subject to a shareholder's demand, that is, whether it has been constructively received, is a factual determination made on a case by case basis.[127]

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[118] *Fehrs Fin. Co. v. Commissioner*, 58 T.C. 174, 194 (1972).

[119] 156 F.2d 398 (7th Cir. 1946).

[120] However, in *Commissioner v. Am. Light & Traction Co.*, 156 F.2d 398 (7th Cir. 1946), the Seventh Circuit held that the date of receipt is the proper time to include the distribution in the shareholder's gross income regardless of whether the shareholder is a cash or accrual method shareholder, suggesting that to include the distribution in shareholders' gross income at different times depending on whether a shareholder is a cash or accrual method shareholder could result in the distribution being taxable to one shareholder and nontaxable to another, depending on the amount of earnings and profits available to the corporation at the time of inclusion. See III.C.1., below.

[121] *See* Reg. §1.301-1(c). *Cf.* Reg. 62, Art. 1541 (pre-1954 Code).

[122] 156 F.2d 398 (7th Cir. 1946). *See also Commissioner v. Tar Prods. Corp.*, 130 F.2d 866 (3d Cir. 1942); *Dynamics Corp. of Am. v. United States*, 392 F.2d 241 (Ct. Cl. 1968).

[123] 292 U.S. 210 (1934).

[124] *See also* Reg. §1.451-2(b); Rev. Rul. 64-290, *amplified by* Rev. Rul. 65-23.

[125] *Bush Bros. & Co. v. Commissioner*, 73 T.C. 424, 438–439 (1979), *aff'd*, 668 F.2d 252 (6th Cir. 1982).

[126] Of note, shareholders who receive cash in a transaction that occurs on December 31 may not have access to the cash until after the new year begins (e.g. a declared reverse split) even though the transaction is reported for other tax purposes on December 31 such as on Form 8937, *Report of Organizational Actions Affecting Basis of Securities*, which reports an organization's actions affecting tax basis.

[127] *See* PLR 201741012 (declared but unpaid dividends that were recorded in the company's general ledger were deemed to be constructively received in years declared and not years of actual receipt because paying corporations were solvent with sufficient assets available at time of declaration following local

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In *A.D. Saenger, Inc. v. Commissioner*,[128] the corporation declared a dividend in 1929. The corporation appropriated the amount of the dividend on its books and credited these amounts to the drawing accounts of the shareholders. Although the shareholders did not draw on the amounts, the Fifth Circuit held that the dividends were received by the shareholders in 1929 even though they were cash basis shareholders. In support of its holding, the court stated that the dividends were unqualifiedly made subject to the taxpayers' demands. The Fifth Circuit found that the financial situation of the corporation was such that, even if it did not have sufficient cash on hand to pay the dividends, the corporation, upon the demand of any of its shareholders, could have borrowed upon or sold some of its investments to pay the dividends.

In *Bay Ridge Operating Co. v. Commissioner*,[129] the Tax Court applied the three-part test in determining that, because an agreement between a parent corporation and its subsidiary did not restrict the parent's right to receive a dividend, the parent was taxable on the entire dividend even though only a portion was received before the end of the parent corporation's fiscal year.

Roe v. Commissioner[130] raised the issue of whether payments to shareholders from 1943 through 1945 pursuant to resolutions adopted in 1926 were dividends in those years or were payments on debts due since 1926 (when the dividends were declared). The Fifth Circuit determined that, in 1926, the corporation had more than adequate income to cover the payments and noted that the dividends were recorded on the books of the corporation as accounts payable. The Fifth Circuit found that a debtor-creditor relationship was created even though the resolution directed the dividends to be paid "as cash was available." Therefore, the court held that the payments made in satisfaction of this debt had to be treated as such and not as taxable distributions.

Practice Point: The requirement that the corporation be able to fulfill the dividend is applied loosely. For example, if a corporation is illiquid but has assets or borrowing power, courts generally find that the corporation can fulfill the dividend.

In *Cox v. Commissioner*,[131] the taxpayer owned 100% of the stock of a regulated investment company (RIC) and a corporation. The taxpayer sold the stock of the corporation to the RIC in exchange for five notes. The RIC had no earnings and profits at the time. The taxpayer realized a long-term capital gain from the transaction and elected to report the gain on the installment method under §453. Although the IRS agreed that a capital gain was recognized on the transaction, it argued that this gain had to be reported in the taxpayer's income in the year of sale and not under §453. The Tax Court concluded that §304(a)(1) recast the stock sale as a contribution to capital followed by a redemption distribution to which §301 applied and, therefore, a sale did not take place under §453.[132] The court explained that, when a distribution is made in excess of earnings and profits, the part of the distribution exceeding the stock's adjusted basis is recharacterized as capital gain under §301(c)(3)(A). However, the court reasoned, because §301(c)(3)(A) did not recast the transaction as a sale, all the distributions had to be accounted for identically, and, therefore, the entire gain had to be reported in the year in which the redemption payments were made.

Note: The result in *Cox* was not affected by the amendment to §453 by the Installment Sales Revision Act of 1980[133] (amending §453(b) to require only that a "disposition," rather than a "sale," occur) because the Tax Court also held that, under Reg. §1.301-1(b) (later redesignated as Reg. §1.301-1(c)), all the shareholders were placed under one tax accounting method for reporting corporate distributions and, thus, could not use the installment method.

3. *Special Rule — Consolidated Returns*

In the consolidated return context, the timing of receipt of a distribution may be accelerated. Reg. §1.1502-13(f)(2)(iv) contains an entitlement rule treating a distributee member as taking a distribution into account when that member becomes entitled to it, generally on the record date. If a corporation does not expressly have a record date for a distribution, the date that a shareholder's sale of stock would no longer shift the shareholder's entitlement to the distribution under state law is generally used as the entitlement date. Thus, under the regulation, if a distributee member becomes entitled to a distribution before it is made, the distribution is deemed made when the member becomes entitled to it. This rule was adopted by the IRS to thwart a particular dividend-stripping transaction in which a parent sells a subsidiary after the record date but before the payment date.[134] For a detailed discussion of the transaction and the remedial regulations, see 755 T.M., *Consolidated Returns — Investment in Subsidiaries*, at V.C.1.

D. *Gifts, Sales, or Other Assignments of Dividends or Stock*

1. *Gifts*

On a gift, sale, or other type of transfer of stock, it is important to determine whether the dividend income is to be reported by the transferor or the transferee. A transferor often assigns the right to receive future distributions without transferring the underlying stock. In these cases, the transferor generally cannot shift the taxation of the dividends to the assignee.

In *Dunham v. Commissioner*,[135] for example, the taxpayer transferred shares of stock to her children. Several days later,

authorities' seizure of the taxpayer's assets and suspended corporate distributions).

[128] 84 F.2d 23 (5th Cir. 1936).

[129] T.C. Memo 1970-19.

[130] 192 F.2d 398 (5th Cir. 1951).

[131] 78 T.C. 1021 (1982).

[132] *Cf. Ruf v. Commissioner*, T.C. Memo 1993-81 (shareholder's transfer of stock in one corporation owned by shareholder to another corporation also owned by shareholder in exchange for note was installment sale rather than contribution to capital and loan from corporation; court apparently declined to consider IRS's §304 argument because it was not raised before trial).

[133] Pub. L. No. 96-471, §2.

[134] The rule replaces a rule that, when a consolidated group member disposed of another member's stock after a dividend had been declared but before it was paid, the dividend was deemed made immediately before disposition of the stock. Because the distribution was received after deconsolidation of the distributor member, the distributee took the position that the distribution did not reduce the basis of the distributee's stock, thus setting up a loss (or reduced gain) on the sale of the stock; the distributee also claimed the DRD with respect to the distribution.

[135] 35 T.C. 705 (1961).

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the children entered into "trust agreements" with respect to the stock that provided for irrevocable assignments to the taxpayer of all income from the stock, possession of which was held by the "trustees." The children also entered into a written assignment transferring all right, title, and interest to the income produced by the stock. Cash dividends on the stock held by the "trustee" were paid directly to the taxpayer. The Tax Court found that these arrangements were not trusts taxable under the terms of the Code, but were custodial arrangements in which the children conveyed only income, retaining for themselves substantially all other incidents of ownership. The court took note of the often cited judicial principle that an assignor of the fruit of the tree cannot escape tax unless he or she also assigns the tree and gives up sufficient control. The court held that, because the taxpayer had no interest in the tree (the stock) and was powerless to influence the growth of the fruit (the dividends), she was not taxable on the dividends. After the taxpayer's son authorized the trustees to take record title and the trustees had the right to vote the stock, the taxpayer had an equitable interest in the stock itself as a beneficiary of the trust and, thus, was taxable on the dividends paid.

When a taxpayer gives, sells, or assigns stock, but retains the dividend rights thereon, there is generally no anticipatory assignment of income and the taxpayer is taxable on the dividends.[136] In *Overton v. Commissioner*[137] (a case involving gift tax liability before the unlimited marital deduction for gifts between spouses), the taxpayers were the sole shareholders of a corporation. In 1936, a recapitalization of the corporation reorganized the outstanding common stock into two classes of common stock, Class A and Class B. Class B stock had a liquidating value of $1 per share, with all other assets upon liquidation belonging to the holders of Class A stock who also had sole voting rights on directors and all ordinary matters. Class A stock was to receive dividends of $10 a share before the payment of any dividend on the Class B stock, and, if dividends in excess of $10 per share were paid in any year, the excess dividends were to be shared by both classes of stock in the ratio of one-fifth for the Class A stock to four-fifths for the Class B stock. The taxpayers gave the Class B stock to their wives. The Second Circuit held that the arrangement, although made in the form of a gift of stock, was in reality an assignment of part of the taxpayers' future dividends, because the Class B stock represented only $1,000 of corporate assets. The property earning the large dividends received by the Class B shareholders was the property represented by the Class A stock held by the taxpayers. The taxpayers, in transferring the Class B stock to their wives, parted with no substantial part of their interest in the corporate assets; in effect, they gave their wives nothing but the right to future earnings flowing from property retained by the taxpayers. Accordingly, the court held that the dividends received by the wives were income of the husbands.

Even when both asset and income are assigned, questions often arise as to the timeliness of the assignment. In Rev. Rul. 74-562, dividends on stock owned by an estate and payable to the life income beneficiary of the residuary estate were declared on November 27, 1973, to be payable on or before December 31, 1973. On December 30, 1973, the life income beneficiary assigned her entire interest in the residuary estate to an existing tax-exempt charitable foundation. The dividends were received by the estate on December 31, 1973, and paid to the charitable foundation. The IRS ruled that, because the right to receive the dividends had accrued to the life income beneficiary before the assignment, the dividends were taxable to her.[138]

In *Caruth Corp. v. United States*,[139] on the other hand, the taxpayer donated preferred stock to an unrelated charity shortly after dividends had been declared on the stock but a few days before the dividend record date. The charity collected the dividends. The IRS did not question the donor's charitable deduction for the amount of the stock's value, which was inflated by the declared dividend, because the tax code in effect in the year of the transaction (1978) allowed a deduction for the full, appreciated value of a donated asset. The IRS claimed, however, that to the extent the value of the stock was attributable to the imminent dividend payment, the increase in value was income chargeable to the taxpayer. The Fifth Circuit rejected the IRS's argument, holding that the dividend did not vest until the record date under the applicable state (Texas) law, and, therefore, the dividend was not taxable to the taxpayer, who was entitled to a deduction in the amount of the full appreciated value of the stock. In so holding, the court distinguished this case from *Estate of Smith v. Commissioner*,[140] in which the Third Circuit held that, under New Jersey law, dividends vest on the declaration date.

Note: Former §57(a)(6) provided an alternative minimum tax preference for contributions to charity of appreciated property, limiting the amount of the charitable deduction to the adjusted basis of the contributed property. Since the repeal of this preference, a deduction in the amount of the property's fair market value is generally permitted.[141] This treatment is consistent with the *Caruth* holding.

2. *Sales and Other Assignments*

Reg. §1.61-9(c) governs the taxability of dividend income when the stock has been sold. When stock is sold before a dividend is both declared and paid, the dividend is income to the purchaser. However, when stock is sold after a dividend is declared and after the record date, the dividend generally is income to the seller.[142] Reg. §1.61-9(c) further provides that when stock is sold between the dividend declaration date and the payment date, the dividend ordinarily is taxable to the purchaser, even if the purchaser included the dividend amount in the purchase price in contemplation of receiving the dividend. If the seller retains legal title to the stock as trustee solely to secure payment of the purchase price — with the understanding that the seller is to reduce the purchase price by the amount of div-

[136] *Bettendorf v. Commissioner*, 49 F.2d 173 (8th Cir. 1931); *Shellabarger v. Commissioner*, 38 F.2d 566 (7th Cir. 1930); *Heminway v. Commissioner*, 44 T.C. 96 (1965).

[137] 162 F.2d 155 (2d Cir. 1947).

[138] *See also Estate of Smith v. Commissioner*, 292 F.2d 478 (3d Cir. 1961); *Newman v. Commissioner*, 1 T.C. 921 (1943).

[139] 865 F.2d 644 (5th Cir. 1989), *aff'g* 688 F. Supp. 1129 (N.D. Tex. 1987).

[140] 292 F.2d 478 (3d Cir. 1961).

[141] Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §13171. This amendment applies to donations of appreciated property, except tangible personal property, made after December 31, 1992, and to donations of tangible personal property made after June 30, 1992.

[142] Reg. §1.61-9(c).

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idends received — the dividends are considered income to the purchaser.

Before income can be considered to have accrued, a definite amount must be distributed and an identified taxpayer must receive the distribution. The mere declaration of a dividend, without an established record date, is insufficient to determine whether income has accrued to a particular taxpayer.[143]

In Rev. Rul. 82-11, a corporation declared a dividend on its preferred stock in May 1980. It set a record date of June 15, 1980, and a payment date of June 21, 1980. The stock exchange set an ex-dividend date[144] of June 21, 1980. The rules of the stock exchange provided that when the ex-dividend date occurred after the record date and stock was sold between the record date and the ex-dividend date, the seller had to sign an agreement that the purchaser was entitled to the dividend. A shareholder of the corporation declaring the dividend sold its shares of preferred stock to another corporation on June 18, 1980. The IRS stated that the record date determines entitlement to a dividend and that the rules of the stock exchange do not control the determination of entitlement to a dividend for federal income tax purposes. Therefore, the IRS ruled that the seller had dividend income and could claim a dividends received deduction.

In *Silco, Inc. v. United States*,[145] a corporation declared a cash dividend. The taxpayer had purchased shares of stock after the record date but before the ex-dividend and payment dates (which in this instance were the same). The seller received the dividends from the corporation and then remitted the appropriate amounts to the taxpayer in accordance with stock exchange rules. The taxpayer reported the dividends, less a dividends received deduction, as taxable income and reported a net capital loss as well. The IRS argued that the concept of entitlement is analogous to the concept of accrual discussed in *Estate of Putnam v. Commissioner*.[146] The IRS contended that once the recipient and the amount of the dividend are identifiable, the income accrues and entitlement is determined. Although it rejected the IRS's reliance on *Estate of Putnam* (because it did not address corporate rights versus stock exchange entitlement), the Fifth Circuit in *Silco* stated that no court had interpreted the effect of Reg. §1.61-9(c) on transactions occurring after the corporate record date but before a stock exchange's ex-dividend date and, therefore, it would follow the interpretation of the IRS in effect on the purchase date in question. Citing Rev. Rul. 57-567 and Rev. Rul. 64-68, the court stated that, although these rulings conflicted with a subsequently published IRS ruling,[147] they did suggest to buyers at the time of the purchase that the IRS would adhere to an economic reality theory. Therefore, the court held that the taxpayer was the actual owner of the dividends and could report them as income.

In *Cukor v. Commissioner*,[148] the taxpayer was the sole shareholder of a corporation that declared a dividend on July 26, 1962. On the same day, the taxpayer exchanged his stock for the stock of another corporation that had been created the day before. The resolution declaring the dividend contemplated that the new corporation would become the sole shareholder and provided explicitly for payment of the dividend directly to the new corporation. The dividend was paid on July 30, 1962, and there was no record date. The court held that the taxpayer never became entitled to the dividend because it was made payable to the new corporation at the outset.

If stock is redeemed and a dividend has been declared before the call for redemption, the amount of the dividend included in the total redemption payment is a §301 distribution.[149] However, if stock is redeemed and the redemption payment includes dividends accrued on the redemption date but not yet declared, the accrued dividends are considered payment for the stock surrendered under §302.[150] Amounts included in a redemption payment for preferred stock representing a quarterly dividend not yet declared but for which funds were set apart and which remain unpaid after payment of common stock dividends for the same period, in violation of the terms of the preferred stock, are dividends to the redeeming shareholders.[151]

In TAM 8828003, the taxpayer made loans of common stock in a "fail sale" transaction, a transaction in which securities are loaned to a broker to cover sales of stock by sellers who own the shares but whose certificates are lost or have not been delivered to the broker. Under the taxpayer's lending agreement with the broker, all borrowed stock and all dividends paid on the stock while on loan were to remain the property of the taxpayer. The National Office advised that the taxpayer was not entitled to the dividends received deduction under §243(a) with respect to dividends received on the loaned stock (while on loan) because, in a fail sale transaction, the stock is sold and is not the property of the lender (the taxpayer) on the ex-dividend date.

[143] *Estate of Putnam v. Commissioner*, 324 U.S. 393 (1945).

[144] When stock trades ex-dividend, the seller usually is entitled to a dividend that has been declared but not yet paid. Generally, the exchange designates stock as ex-dividend a few days before the record date. The effect is to make the owner of the stock on the ex-dividend date and the holder of the stock on the record date the same party, because it normally takes a few days for the corporation to substitute the purchaser for the seller as the shareholder on its books. However, a stock exchange may alter this general rule by setting the ex-dividend date after the record date in certain situations, such as when a large dividend is declared. *See* Rev. Rul. 82-11. This ruling is supported by GCM 38721 (May 1, 1981) and GCM 38502 (Sept. 18, 1980), which elaborate on the NYSE rules.

[145] 779 F.2d 282 (5th Cir. 1986), *rev'g and rem'g* 591 F. Supp. 480 (N.D. Tex. 1984).

[146] 324 U.S. 393 (1945).

[147] Rev. Rul. 82-11.

[148] T.C. Memo 1968-17.

[149] Rev. Rul. 69-130. This rule is based on the theory that when the dividend is declared the shareholder has a vested right in a creditor capacity against the corporation. The dividend is a separate property right disconnected from the stock and, as such, is not paid in cancellation or redemption of the stock.

[150] Rev. Rul. 69-131. *See also Cummins Diesel Sales Corp. v. United States*, 323 F. Supp. 1114 (S.D. Ind. 1971), *aff'd per curiam*, 459 F.2d. 668 (7th Cir. 1972); *Estate of Mathis v. Commissioner*, 47 T.C. 248 (1966).

[151] *Gidwitz Family Trust v. Commissioner*, 61 T.C. 664 (1974); *Crown v. Commissioner*, 58 T.C. 825 (1972), *aff'd by unpub. opin.*, 487 F.2d 1404 (7th Cir. 1973). These cases emphasize that legal obligation to pay the dividend existed before the redemption and, accordingly, had priority over the redemption. *See also* Rev. Rul. 75-320.

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3. *Waivers of Dividends*

A controlling shareholder who waives the rights to a dividend in favor of the non-waiving, unrelated minority shareholders generally is not in constructive receipt of the dividend income if the waiver serves a bona fide business purpose.[152] The policy of permitting a shareholder to waive dividends without being in constructive receipt of the dividend income arises from cases holding that a corporation is not required to declare a pro rata dividend;[153] non-pro rata distributions are not automatically reapportioned pro rata.

a. *Bona Fide Business Purpose*

Rev. Rul. 71-164[154] provides an example of a bona fide business purpose for a dividend waiver. The taxpayer was the director of a national banking association and owned 100 shares of stock in the national bank, as required by federal banking laws. The remainder of the shares was owned by the parent holding corporation. The taxpayer, when he purchased the stock, entered into a repurchase agreement to sell the shares back to the parent holding corporation upon termination of his directorship. The agreement also provided that the taxpayer would waive all dividends in excess of the quarterly dividend of 50 cents per share. The IRS ruled that the taxpayer was not in constructive receipt of dividend income with respect to dividend payments in excess of the quarterly dividend of 50 cents per share.

However, as indicated in Rev. Rul. 56-431, if a controlling shareholder waives dividend rights and the minority shareholders are related to the controlling shareholder, the controlling shareholder may be deemed to have received a constructive dividend. The waiver of dividend rights is, in essence, a gift in this situation.[155] For a discussion of constructive dividends, see IV.F., below.

Another bona fide purpose for waiving the right to dividends may relate to what is commonly referred to as "hook stock" where a subsidiary owns stock in its parent company shareholder.[156]

b. *Control Over Corporate Distributions*

The courts have held that a taxpayer must exercise some control over the corporation to be in receipt of a constructive dividend. In *Estate of Hodgkins v. Commissioner*,[157] the taxpayer owned approximately 45% of the corporation's stock. Her ex-husband owned approximately 54% and her children the remainder. The corporation made payments to her adult children, which they reported as dividends on their returns. The IRS sought to treat the payments as constructive dividends to the taxpayer on the theory that they were made at the direction of a controlling shareholder for the economic benefit of her family. The Tax Court pointed out that the taxpayer was a minority shareholder who had no control over corporate distributions. Therefore, it held that the taxpayer was not in receipt of a constructive dividend.

In *Green v. United States*,[158] the taxpayers were a husband and wife owning approximately 11% of the stock of a corporation of which the husband was president and director. The corporation offered to sell mineral interests to its shareholders for what the IRS contended was a bargain price. The husband allowed his children to purchase his pro rata portion of the mineral interests. The IRS contended that this was a constructive dividend to the husband. The Fifth Circuit, agreeing with the IRS, stated that the test for a constructive dividend attributable to a waiver is whether the taxpayer has exercised substantial influence over the corporation. The court distinguished *Hodgkins* as a case in which the taxpayer did not hold a controlling corporate interest or an unquestioned power to compel payment of income. In *Green*, the court concluded, because the husband was president and director of the corporation, he exercised substantial influence and, therefore, was in receipt of a constructive dividend.

c. *IRS Ruling Position*

In Rev. Proc. 67-14,[159] the IRS stated that it will issue an advance ruling on a proposed dividend waiver if a family relationship exists between the waiving and the remaining shareholders, provided (i) a bona fide business purpose for the waiver exists and (ii) the relatives[160] of the waiving shareholder are not in a position to receive more than 20% of the total dividends distributed to non-waiving shareholders. When a ruling is issued, it is effective for up to three years from the date of the ruling and is not applicable if a change in stock ownership enables non-waiving relatives to receive more than 20% of the total dividends distributed to non-waiving shareholders unless the change occurs because of death.[161]

d. *Waiver vs. Exchange of Dividend Right for Consideration*

A taxpayer's exchange of the right to receive dividends for other property is not a waiver. In *Fisher v. Commissioner*,[162] the taxpayer exchanged stock that he held as sole shareholder of his corporation for stock in another corporation. On the stock to be received by the taxpayer, dividends were to accrue after a certain date regardless of the actual closing. The agreement was modified to provide that no cash dividends would accrue and, instead, the taxpayer would receive additional stock. The

[152] Rev. Rul. 65-256; Rev. Rul. 45, 1953-1 C.B. 178. *See also* PLR 9650006.

[153] *58th St. Plaza Theatre Inc. v. Commissioner*, 195 F.2d. 724 (2d Cir. 1952); *Bagley v. United States*, 348 F. Supp. 418 (D. Minn. 1972); *Baird v. Commissioner*, 25 T.C. 387 (1955).

[154] *See also* PLR 199944021 (ruling renewed in PLR 200312016).

[155] *See also Snyder v. Commissioner*, 93 T.C. 529 (1989) (by failing to exercise right to convert preferred stock entitled to noncumulative dividends to preferred stock entitled to cumulative dividends, taxpayer made gift for gift tax purposes of unclaimed dividend accruals to common shareholders, who were great-grandchildren of taxpayer).

[156] The treatment of dividends received by a subsidiary is unknown, including the application of the DRD described below. As a result, corporate taxpayers related to the payor often waive the receipt of these dividends.

[157] T.C. Memo 1965-225.

[158] 460 F.2d 412 (5th Cir. 1972).

[159] See PLR 201114006, PLR 200820019, and PLR 9727012 for examples of rulings issued pursuant to Rev. Proc. 67-14.

[160] Rev. Proc. 67-14 defines "relatives" as including siblings (by whole or half-blood), spouses, ancestors, lineal descendants, spouses of siblings, and spouses of lineal descendants.

[161] For an extension of Rev. Proc. 67-14 to a situation in which the waiving shareholder was a corporation (and thus without "relatives"), see PLR 199944021.

[162] 62 T.C. 73 (1974).

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Tax Court held that the taxpayer's agreement to receive the dividend in a different form did not affect his taxability. This was not a waiver situation, because the taxpayer received consideration, i.e., additional stock. The taxpayer exchanged the right to receive an amount taxable as ordinary income for valuable property. Therefore, the court held, the taxpayer had received a distribution under §301.

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IV. Non-Cash and Deemed Dividends

A. In General

Although the most common type of dividend is a cash distribution, other distributions are also regarded as, or may be deemed to be, dividends. Such other distributions may include distributions of bonds of a corporation other than the distributing corporation or government bonds,[163] real property,[164] or stock in a corporation other than the distributing corporation.[165] In addition, under §305, a distribution of the stock of the distributing corporation (or other device) may be deemed to be a dividend if, for example, it is used to preserve (or increase) the equity interests of one class of shareholders when cash or property is distributed to holders of another class of stock. Similarly, the IRS may recharacterize as constructive dividends certain transactions that are not formally declared dividends. Transactions between a corporation and its shareholders, or between a corporation and third parties, for example, may be recharacterized as constructive dividends. Transactions between affiliated corporations likewise may result in constructive dividend treatment for their common controlling shareholders.

B. Distributions in Kind

The phrase "distribution in kind" generally refers to a distribution of property other than money or the distributing corporation's own stock or rights to acquire such stock. Distributions "in kind" by a corporation to its shareholders may consist of various types of property. Generally speaking, a shareholder is treated as receiving a distribution equal to the distributed property's fair market value less liabilities assumed by the shareholder.[166] The shareholder's basis in the property received is the property's fair market value.[167]

For a detailed discussion of the tax consequences of distributions to shareholders, see V. and VI., below.

Instead of distributing cash or property, the corporation may make a distribution of its own obligations. The example contained in Reg. §1.301-1(j) implies that the distribution of a corporation's own obligations is a distribution to which §301 applies.[168]

While it is typically not controversial whether a distribution is a distribution of cash or other property, there have been situations where this question was in dispute. For example, in *Cordner v. United States*,[169] taxpayers received gold coins as a dividend distribution. At issue in that case was whether the gold coins were money or a distribution of property, because that determination would affect the amount of the distribution. The Ninth Circuit stated that, if legal tender has a fair market value in excess of the face value or tender because of its value to collectors or the intrinsic worth of its contents, it should be deemed to be property other than money for purposes of determining the amount of the distribution under §301(b)(1).[170] Accordingly, the court held that the gold coins, although legal tender and money for some purposes, were property because they were withdrawn from circulation and had numismatic worth.

C. Section 305

1. In General

To provide value to shareholders without depleting a corporation's assets, corporations may distribute stock of the corporation to its shareholders. A corporation may also distribute rights to acquire its stock to shareholders in the form of a subscription right. Companies may choose to issue rights to shareholders as opposed to stock for a variety of bona fide corporate reasons (e.g. part of a poison pill, capital raises that may have other federal tax benefits, etc).

Section 305(a) provides that a distribution of stock to its shareholders is not a taxable dividend. Section 305(b) provides an exception to §305(a) and requires that either actual or deemed distributions of stock in the distributing corporation must be treated as distributions of property to which §301 applies if one of the following exceptions are met:[171]

(1) if the distribution, at the election of any of the shareholders, is payable in the corporation's own stock or in property;[172]

(2) if the distribution results in the receipt of property by some shareholders and an increase in the proportionate interest of other shareholders in the assets or earnings and profits of the corporation;

(3) if the distribution results in the receipt of preferred stock by some common shareholders and common stock by other common shareholders;

(4) if a distribution of stock is made on preferred stock, unless it is due to an increase in the conversion ratio of

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[163] Reg. §1.317-1.

[164] *Hines v. United States*, 90 F.2d 957 (7th Cir. 1937); Rev. Rul. 56-512.

[165] Reg. §1.61-9(b). *See Cheley v. Commissioner*, 131 F.2d 1018 (10th Cir. 1942). Stock in another corporation is property even if the two corporations are affiliated. *See Golden State Theatre & Realty Corp. v. Commissioner*, 125 F.2d 641 (9th Cir. 1942); Rev. Rul. 70-296. *See also Weigl v. Commissioner*, 84 T.C. 1192 (1985) (distribution by corporation to its shareholders of options to acquire stock in another corporation is distribution of property).

[166] §301(b)(1), §301(b)(2); Reg. §1.301-1(b), as amended by T.D. 9954, 86 Fed. Reg. 52,612 (Sept. 22, 2021), to update Reg. §1.301-1 to reflect statutory amendments made to §301(b)(1) in 1988.

[167] §301(d); Reg. §1.301-1(g), as amended by T.D. 9954, 86 Fed. Reg. 52,612 (Sept. 22, 2021), to update Reg. §1.301-1 to reflect statutory amendments made to §301(d) in 1988.

[168] Before the regulations were amended by T.D. 9954 to reflect statutory changes made to §301 in 1988, former Reg. §1.301-1(d)(1)(ii) provided that the amount of distribution to be taken into account with respect to a corporate shareholder included an amount equal to the fair market value of any property distributed, which consisted of, among other things, any obligations of the distributing corporation. The amendments to the regulations eliminated the distinction between distributions to corporate and noncorporate shareholders and, therefore, former Reg. §1.301-1(d) was deleted as obsolete. However, the regulations retained former Reg. §1.301-1(l) (including the example implying that §301 applies to a distribution of a corporation's own obligations) and redesignated it as Reg. §1.301-1(j).

[169] 671 F.2d 367 (9th Cir. 1982).

[170] *See also Am. Home Prods. Corp. v. United States*, 601 F.2d 540 (Ct. Cl. 1979) (dividend declared in foreign currency by foreign corporation was treated as property dividend and measured by prevailing exchange rate at time of distribution).

[171] Deemed distributions can include a §302(d) redemption (including stock buyback program) or a change in the conversion ratio of a preferred instrument.

[172] *See, e.g.*, PLR 200615024 (distribution of taxpayer's pre-REIT election E&P, for which shareholders elect payment in cash, taxpayer's stock, or combination of cash and stock, was treated as distribution of property to which §301 applied), PLR 200348020 (same).

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convertible preferred stock solely to take account of stock dividends or stock splits on the stock into which the convertible stock can be converted; and

(5) if there is a distribution of convertible preferred stock on common stock, unless the shareholder can prove that the distribution will not result in a disproportionate distribution.

Section 305(c) provides that other transactions, such as a change in conversion ratio or a change in redemption price, may be treated as distributions to which §301 applies with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such transactions.

Preferred stock instruments often have terms that allow the shareholder of the stock to receive cash or a class of stock as distributions to pay the dividends on the instrument. The preferred instrument may also have a conversion feature that allows the shareholder to convert its preferred stock interest into another class of stock. A change in conversation ratio under §305(c) and Reg. §1.305-7(a) confirms that a shareholder whose proportionate interest may be treated as distribution of property unless it is made for a "bona fide reasonable adjustment formula." Determining whether there should be a distribution in light of a change in conversion ratio can be based on whether the adjustment related entirely to cash or stock.[173]

Similarly, issuers of convertible securities typically adjust the conversion ratio of the convertible securities upon issuing a dividend to its common shareholders to increase the number of shares to which the instrument is convertible to prevent dilution of the convertible security holders' interests. Reg. §1.305-7(b)(1) provides that an adjustment made under a bona fide and reasonable adjustment formula that prevents this dilution is not a deemed distribution of stock under §305(b).[174] Conversely, an adjustment that is not deemed to be reasonable may be a distribution under §305(b) and taxed as a dividend to the extent of earnings and profits. The current Treasury Regulations, however, are unclear as to the amount and timing of the distribution that would be taken into account.

Section 305 can also create a constructive dividend when a corporation offers an inducement to exercise a warrant at a lower exercise price. The exception to §305(a) contained in §305(b)(2) can apply if the inducement is viewed as a disproportionate increase in the stock of the warrant holders. Warrant holders may be viewed as shareholders for purposes of §305 and any reduction in the exercise price could create an increase in the warrant holder's proportionate interest in the E&P and assets of the issuing corporation without a corresponding increase in the other shareholders' interests, potentially creating a constructive dividend to the warrant holders.

2. *Amount of the Deemed Dividend*

On April 12, 2016, the IRS released Prop. Reg. §1.305-7 to clarify the amount and timing of the deemed distributions that arise when a change has been made to the ratio of a convertible instrument. Under the proposed regulations, the amount of the deemed distribution would be the excess of (i) the fair market value of the right to acquire stock immediately after the applicable adjustment over (ii) the fair market value of the right to acquire stock without the applicable adjustment. In determining the fair market value of a right to acquire stock, any particular facts pertaining to the deemed shareholder's rights, including the number of actual shares of stock or rights to acquire stock held by such deemed shareholder, would be disregarded.[175]

3. *Timing of the Deemed Dividend*

The deemed distribution occurs at the time such applicable adjustment occurs, in accordance with the instrument setting forth the terms of the right to acquire stock, but in no event later than the date of the distribution of cash or property that results in the deemed distribution taking into account Reg. §1.305-3(b).[176] If the deemed distribution relates to a right to acquire publicly traded stock, if the instrument setting forth the terms of such right does not set forth the date and time the applicable adjustment occurs, the deemed distribution would occur immediately prior to the opening of business on the ex-dividend date for the distribution of cash or property that results in the deemed distribution. If the deemed distribution relates to a right to acquire non-publicly traded stock, if the instrument setting forth the terms of such right does not set forth the date and time the applicable adjustment occurs, the deemed distribution occurs on the date that a holder is legally entitled to the distribution of cash or property that results in the deemed distribution.[177]

4. *Withholding Obligations Related to Section 305*

If certain requirements are met, a withholding agent would be required to satisfy its withholding obligation by withholding on the earliest of (i) the date on which a future cash payment is made with respect to the security; (ii) the date on which the security is sold, exchanged, or otherwise disposed of (including a transfer of the security to another account not maintained by the withholding agent or a termination of the account relationship); or (iii) the due date (not including extensions) for filing Form 1042 with respect to the calendar year in which the deemed distribution occurred.[178] Under this approach, a withholding agent that continues to directly or indirectly hold or own the security when the requirements of Prop. Reg. §1.1441-2(d)(4)(i) are satisfied generally would be able to satisfy its withholding obligation by withholding on future cash payments on the security. If, however, the security is disposed of before sufficient future cash payments have been made on the security, the withhold-

[173] PLR 201312028.

[174] Section 305(c) authorizes the Secretary to prescribe regulations to treat changes in the conversion ratio of instruments convertible into stock and other events having similar effects as distributions to shareholders whose proportionate interests in the assets or earnings and profits of the corporation are increased by such events. *See also* Rev. Rul. 75-513 (§301 applied to deemed distribution where conversion ratio of convertible debentures increased due to payment of cash dividend to common shareholders), Rev. Rul. 76-186 (same; basis of the convertible debentures was increased by the value of the deemed distribution).

[175] Prop. Reg. §1.305-7(c)(4), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016). This section applies to deemed distributions under §305(c) occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

[176] Prop. Reg. §1.305-7(c)(5).

[177] Preamble to REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016).

[178] Prop. Reg. §1.1441-2(d)(4)(ii), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016).

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ing agent would be required to withhold at the time of disposition and generally would be expected to do so by, for example, withholding on the proceeds from the disposal, liquidating other property held in custody for the beneficial owner, or obtaining other funds directly or indirectly from the beneficial owner to satisfy the withholding.[179]

For further discussion of §305, see 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*

D. Tracking Stock

The tax status of tracking stock remains unsettled. According to the Joint Committee on Taxation, the term "tracking stock" describes an issuing corporation's special class of stock that *tracks* the performance or value of one or more of the issuing corporation's assets.[180] Despite this clear statement, the IRS will not rule on whether tracking stock is treated as stock of the issuer.[181] The IRS's reluctance to rule, presumably, is based on its concern that tracking stock, while nominally stock of the issuing corporation, actually represents an interest in a subsidiary of the issuing corporation and, when distributed within the context of a §355 transaction, does not satisfy the statutory requirements of §355.

E. Stapled Stock

Under a stapled stock arrangement, the shares of stock of two corporations are paired so that neither can be disposed of independently. In Rev. Rul. 54-140, the IRS ruled that if a bank distributes all of the stock of its subsidiary to a trust for the benefit of the bank's shareholders and the stock cannot be disposed of without disposing of the bank's stock, a taxable dividend results to the extent of earnings and profits of the bank. The IRS stated that the linkage of the subsidiary stock to the bank stock, so that the bank shareholders receive nothing that can be disposed of separately from the bank stock, does not render the transaction nontaxable.

In *Wilkinson v. Commissioner*,[182] on the other hand, the Tax Court held that the transfer by a bank of stock in its subsidiary to a trust for the benefit of the bank's shareholders was not a taxable dividend to the shareholders. The court explained that what the bank's shareholders received was substantially the same beneficial interest in the stock of the subsidiary that they had before the distribution.

One line of cases involves banks that declared cash dividends or dividends consisting of surplus assets that were, by agreement of the bank's shareholders, paid over to trustees for the purposes of organizing corporations to transact businesses in which the banks could not engage.[183] In these cases, the stock of the new corporation was to be held in trust for the bank's shareholders and its disposition tied to existing stock ownership in the bank. The courts held that the bank's shareholders realized income on the payment of the cash dividend to them. The fact that, by prior agreement, the shareholders' cash dividends were diverted to the purchase of stock was considered immaterial.

For stapled stock arrangements in the foreign context, see §269B.

F. Constructive Dividends

1. In General

Constructive dividends result from many different transactions, including transactions between a corporation and its shareholders, between a corporation and third parties, and between affiliated corporations that have controlling shareholders in common. A constructive dividend can result when a corporation transfers money or other property, without an expectation of reimbursement, to or for the benefit of one or more of its shareholders and the transfer is not characterized or reported as a dividend. For the transfer to trigger constructive dividend treatment, it, like other dividends, must be made with respect to the corporation's stock.[184]

Section 316(a) defines a dividend as any distribution of property by a corporation out of its current or accumulated earnings and profit. Therefore, multiple courts have determined that a corporation has made a constructive dividend when it confers an economic benefit on a shareholder without the expectation of repayment regardless of whether the corporation or the shareholder intend a dividend for constructive dividend treatment to result.[185]

In most constructive dividend cases, the disbursement or transfer determined to be a dividend originally is characterized as a loan, a business expense (e.g., salary, rent, interest, etc.), or consideration for the purchase of a corporate asset. The basic inquiry in ascertaining the true nature of a disbursement or transfer is whether there is in fact a corporate loan, expense, or purchase of an asset to support the transfer and that disbursement or transfer has a valid business purpose.[186] A withdrawal of money or property from the corporation other than to satisfy its corporate obligations or to acquire an asset generally is a dividend.[187]

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[179] Preamble to REG-133673-15, 81 Fed. Reg. 21,795, 21,798 (Apr. 13, 2016).

[180] Staff of the Joint Comm. on Tax'n, "Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal," JCS-2-00, at 366 (2000).

[181] Rev. Proc. 2026-3, §3.01(150). *See* PLR 200314018.

[182] 29 T.C. 421 (1957), *nonacq.*, 1960-1 C.B. 7.

[183] *Twohy v. Commissioner*, 34 B.T.A. 444 (1936); *Hopkins v. Commissioner*, 27 B.T.A. 1331 (1933); *Lonsdale v. Commissioner*, 11 B.T.A. 659 (1928), *aff'd*, 32 F.2d 537 (8th Cir. 1929).

[184] For a discussion of constructive dividends to common shareholders arising from transactions between controlled sister corporations, see 6900 T.M., *Transfer Pricing: The Code, the Regulations, and Selected Case Law* (Foreign Income Series), at II.C.3.b.(3)(b).

[185] *Crosby v. United States*, 496 F.2d 1384, 1388 (5th Cir. 1974); *Hood v. Commissioner*, 115 T.C. 172 (2000); *Santos v. Commissioner*, T.C. Memo 2019-148.

[186] *Benjamin v. Commissioner*, 66 T.C. 1084, 1115 (1976), *aff'd* 592 F.2d 1259 (5th Cir. 1979) (corporation's noncompensatory payment on behalf of shareholder without a business purpose or expectation of repayment considered a dividend).

[187] *See, e.g., Coastal Heart Med. Grp., Inc. v. Commissioner*, T.C. Memo 2015-84 (medical practice's payment to construction company for installation of CT scanner was §316(a) constructive dividend to taxpayer, and was unreported income for taxpayer, because taxpayer primarily benefited from this expenditure); *Sammons v. Commissioner*, 472 F.2d 449 (5th Cir. 1972) (transfer of corporate funds from parent to subsidiary to enable subsidiary to pay parent's debt to controlling shareholder, which was subject to indemnity agreement between parent and shareholder, was not constructive dividend). *See also King's Court Mobile Home Park, Inc. v. Commissioner*, 98 T.C. 511 (1992) (diverted funds were constructive dividends, not wages, because characteriza-

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Practice Point: While there is substantial attention given to objective criteria in determining whether a transaction should be considered a constructive dividend, the determination is often made at the time when the shareholder may have a future obligation to the corporation. Therefore, courts have acknowledged that subjective intent of the parties is not to be totally disregarded.[188]

The distribution or transfer by the corporation must primarily benefit the shareholder.[189] The benefit may be conveyed either through a distribution by the corporation to a third party for the benefit of a shareholder or to satisfy the shareholder's purposes,[190] or through a distribution of corporate earnings or assets for the private purposes of the shareholder.[191]

For example, in *McCabe Packing Co. v. United States*,[192] a district court held that a constructive dividend did not result because no corporate asset was distributed when the taxpayer, who was the secretary and treasurer of the corporation, derived income from using otherwise worthless corporate property to develop a line of business that the corporation had rejected. Because the property was otherwise worthless and the corporation had turned down the opportunity, the court determined that the income generated was never corporate income that the taxpayer received as a dividend but, rather, was the taxpayer's personal business income.

By comparison, in *Eng'g Sales, Inc. v. United States*,[193] the Fifth Circuit determined that the taxpayers had received a personal benefit from a distribution to their children and, thus, had received a constructive dividend. The taxpayers were the two shareholders of a manufacturing corporation and the parents of the shareholders of a marketing corporation. The parents' manufacturing corporation sold its products to the children's marketing corporation for the exact labor and equipment costs that it incurred plus 7.8% of the gross revenue derived by the marketing corporation. The court upheld the IRS's determination that distributions by the marketing corporation to its shareholders (the taxpayers' children) as a dividend was a constructive dividend to the shareholders of the manufacturing corporation (the taxpayers). The court speculated that the IRS's determination of a deficiency could have been based on a finding that the intercompany transfer was made primarily to create income for the taxpayers' children.

At first glance, the application of these principles does not seem difficult. The analysis of whether the transaction at issue effects a distribution by the corporation to its shareholder, with respect to its stock, however, has been complicated by additional criteria. For example, some courts have focused on whether the shareholders have received a direct "economic benefit."[194] Other cases have held that the benefit conferred on the shareholder by the questioned distribution or transfer need not be of a direct financial nature but may be merely the pursuit of a hobby, the fulfillment of a moral obligation, or the making of a gift.[195] Because a determination that a corporation has made a constructive dividend is often paired with a determination a shareholder has underreported income, a connection must be established between the income and the shareholder.[196] The determination of a constructive dividend also requires both a finding that a constructive dividend has been conferred and a computation of the amount of the dividend.[197]

a. Constructive Dividend vs. Loan

(1) Loans to Shareholders

Generally, a loan that represents a bona fide indebtedness made by a corporation to its shareholder is not a constructive

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tion of payments as wages was made long after corporation and shareholder failed to timely report income; no evidence that amount of wages, after inclusion of diverted funds, was reasonable compensation).

[188] See, *Alterman Foods, Inc. v. United States*, 505 F.2d 873 (5th Cir. 1974), *aff'g* 73-2 USTC ¶9792 (N.D. Ga. 1973); *Livernois Trust v. Commissioner*, 433 F.2d 879 (6th Cir. 1970), *aff'g* T.C. Memo 1969-111; *Estate of Chism v. Commissioner*, 322 F.2d 956 (9th Cir. 1963), *aff'g* T.C. Memo 1962-6; *Clark v. Commissioner*, 266 F.2d 698 (9th Cir. 1959).

[189] *Loftin & Woodard, Inc. v. United States*, 577 F.2d 1206 (5th Cir. 1978); *Magnon v. Commissioner*, 73 T.C. 980, 994 (1980). *See also Estate of Fry v. Commissioner*, T.C. Memo 2024-8 (payments made from one S corporation to another S corporation at the direction of both corporations' sole shareholder were constructive distributions to the shareholder, who primarily benefited because the payments ensured the recipient corporation's continued operations); *Starer v. Commissioner*, T.C. Memo 2022-124 (controlling shareholders of S corporation received constructive dividend of appreciated property when corporation effectively made gratuitous transfers of real property to a single-member LLC owned by their son-in-law and to unrelated individual with whom shareholders had a business relationship). *Cf. Welle v. Commissioner*, 140 T.C. 420 (2013) (taxpayer did not receive constructive dividend equal to corporation's forgone profit from services that corporation provided during building of taxpayer's home because transactions did not result in distribution of current or accumulated earnings and profits). *See also R.V.J. Cezar Corp. v. Commissioner*, T.C. Memo 2010-173 (because shareholders did not already own improvements that corporation distributed to them, shareholders' argument against constructive dividend treatment failed); PLR 200215036 (discounts provided to shareholders on various items, i.e., food and beverage purchases, golf membership dues, and cart rental and range fees, with respect to corporation's country club, are constructive dividends).

[190] *See, e.g., Dean v. Commissioner*, 57 T.C. 32 (1971); *Idol v. Commissioner*, 38 T.C. 444 (1962), *aff'd*, 319 F.2d 647 (8th Cir. 1963); *Challenge Mfg. Co. v. Commissioner*, 37 T.C. 650 (1962), *acq.*, 1962-2 C.B. 4; *Sparks Nugget, Inc. v. Commissioner*, T.C. Memo 1970-74, *aff'd*, 458 F.2d 631 (9th Cir. 1972). *See also Rapid Elec. Co., Inc. v. Commissioner*, 61 T.C. 232 (1973) (constructive dividend may result even when funds are not distributed directly to shareholder, but mere fact that individual, as sole shareholder, may derive indirect benefit from transfer is insufficient to result in constructive dividend treatment) (citing *Rushing v. Commissioner*, 52 T.C. 888 (1969), *acq.*, 1974-2 C.B. 4).

[191] *Sparks Nugget, Inc. v. Commissioner*, T.C. Memo 1970-74, *aff'd*, 458 F.2d 631 (9th Cir. 1972).

[192] 809 F. Supp. 614 (C.D. Ill. 1992).

[193] 510 F.2d 565 (5th Cir. 1975).

[194] *See Sammons v. Commissioner*, 472 F.2d 449 (5th Cir. 1972) discussed, below, at IV.F.2.b. *See also* PLR 9727007 (shareholders of Alaska Native Corporation (ANC) were taxable on transfer of property to trust of which ANC's shareholders were beneficiaries; shareholders were not in constructive receipt of funds transferred, but IRS concluded that shareholders had received currently taxable distribution because they received economic benefit from transfer).

[195] *W.D. Gale, Inc. v. Commissioner*, 297 F.2d 270 (6th Cir. 1961); *Byers v. Commissioner*, 199 F.2d 273 (8th Cir. 1952); *Commissioner v. Greenspun*, 156 F.2d 917 (5th Cir. 1946); *Montgomery Eng'g. Co. v. United States*, 230 F. Supp. 838 (D.N.J. 1964), *aff'd per curiam*, 344 F.2d 996 (3d Cir. 1965); *Sparks Nugget, Inc. v. Commissioner*, T.C. Memo 1970-74, *aff'd*, 458 F.2d 631 (9th Cir. 1972).

[196] *Gerardo v. Commissioner*, 552 F.2d 549 (3d Cir. 1977), *aff'g in part, rev'g in part* T.C. Memo 1975-341. *See also Palmarini Inc. v. Commissioner*, T.C. Memo 2022-119 (it is not sufficient to assume that any corporate expenditure that is not deductible is a dividend; the IRS must establish a connection with the shareholder and show the payment was primarily for the shareholder's benefit).

[197] *Loftin & Woodard, Inc. v. United States*, 577 F.2d 1206 (5th Cir. 1978); *United Aniline Co. v. Commissioner*, 316 F.2d 701 (1st Cir. 1963); *Challenge Mfg. Co. v. Commissioner*, 37 T.C. 650 (1962), *acq.*, 1962-2 C.B. 4.

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dividend.[198] Whether a corporation's advances to its shareholder are bona fide loans depends upon whether, at the time the advances are made, the shareholder intends to repay the corporation and the corporation intends to enforce the obligations.[199]

In determining whether advances made by a corporation are loans or constructive dividends, i.e., whether the shareholders intended to repay, the courts consider several factors, including:

(1) the extent to which the shareholder controls the corporation;

(2) the earnings and dividend history of the corporation;

(3) the magnitude of the advances;

(4) whether a ceiling limits the amount the corporation advanced;

(5) whether security is given for the advance;

(6) whether there is a set maturity date;

(7) whether the corporation undertakes to force repayment;

(8) whether the shareholder is in a position to repay;

(9) whether the shareholder attempts to repay;

(10) whether interest is charged by the corporation;

(11) whether a certificate of indebtedness is given to the corporation;

(12) whether the terms of an agreement between the corporation and the shareholder establish an absolute and unconditional duty to repay; and

(13) whether the advances are proportionate to the shareholder's stock ownership.[200]

No single factor seems to be determinative. In most cases there are indicia both of a bona fide debtor-creditor relationship and of a constructive dividend. Therefore, the disposition of the loan-versus-dividend issue requires a consideration and weighing of all the facts and circumstances.

In *Bergersen v. Commissioner*,[201] the First Circuit affirmed the Tax Court's decision that amounts paid by a Puerto Rico-based corporation to its sole shareholders were constructive dividends. A husband and wife (H and W) originally formed a Delaware corporation to make and sell products based on the husband's inventions. The corporation's plant was moved to Puerto Rico to take advantage of the §936 possession tax credit. As the corporation's undistributed earnings grew, H and W began borrowing money from the corporation. The corporation carried these amounts as loans on its books. Subsequently, the corporation paid a dividend to H and W, which they treated as exempt from U.S. income tax under §933 and which they immediately paid back to the corporation to reduce their outstanding loans. They asserted that they were entitled to §933 benefits because they had established a residence in Puerto Rico by the time the corporation had paid the dividends. Some of the traditional indicia of loans existed while others were missing. The court determined that, regardless of the formalities, and given that H and W intended to move to Puerto Rico when the funds were taken out of the corporation, there was no inducement for H and W to repay the loans made by the corporation before they moved to Puerto Rico. If H and W did not repay the loans and the corporation instead canceled the loans as a dividend after they moved to Puerto Rico, the dividend would be tax free under §933. For this reason, the court concluded that the transfer of funds to H and W before their claimed Puerto Rican residency began was a permanent transfer to them and, thus, a dividend.

In *Pierce v. Commissioner*,[202] the Tax Court held that one of the two 50% shareholders of a corporation who received numerous advances from the corporation during a six-year period had not received constructive dividends. The court relied on the testimony of the corporation's two shareholders regarding their subjective intention. It also considered other factors, including: (1) the recording of the advances on the corporate books as accounts receivable and evidencing of some by notes; (2) the shareholder's signing, on two separate occasions, two-year noninterest-bearing notes for the aggregate sum due to the corporation on the date thereof, and the securing of one of the two notes by stock owned by the shareholder in another company; (3) substantial repayments, some of which resulted in recognition of gain from a sale or exchange, reported by the shareholder; (4) the fact that the loans made to the borrowing shareholder far exceeded the amount of the loans made to the other share-

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[198] *Pierce v. Commissioner*, 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2. *See also In re Fischer*, 169 B.R. 43 (Bankr. M.D. Tenn. 1994) (advances by closely held corporation to sole shareholder characterized as loans, not dividends, because advances were evidenced by enforceable notes and shareholder's net worth was sufficient to repay advanced amounts); *McCurley v. Commissioner*, T.C. Memo 1997-371 (whether distribution from corporation to shareholder is dividend or loan depends on whether corporation conferred benefit on shareholder without expectation of repayment).

[199] *Alterman Foods, Inc. v. United States*, 505 F.2d 873 (5th Cir. 1974), *aff'g* 73-2 USTC ¶9792 (N.D. Ga. 1973); *Livernois Trust v. Commissioner*, 433 F.2d 879 (6th Cir. 1970), *aff'g* T.C. Memo 1969-111; *Estate of Chism v. Commissioner*, 322 F.2d 956 (9th Cir. 1963), *aff'g* T.C. Memo 1962-6; *Clark v. Commissioner*, 266 F.2d 698 (9th Cir. 1959); *Shea v. United States*, 83-1 USTC ¶9115 (N.D. Ala. 1982); *Pierce v. Commissioner*, 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2; *Haber v. Commissioner*, 52 T.C. 255 (1969), *aff'd per curiam*, 422 F.2d 198 (5th Cir. 1970); *Kaplan v. Commissioner*, 43 T.C. 580 (1965); *Ahlegian v. Commissioner*, T.C. Memo 1975-342, *aff'd*, 556 F.2d 580 (6th Cir. 1977). *See also Crowley v. Commissioner*, 962 F.2d 1077 (1st Cir. 1992), *aff'g* T.C. Memo 1990-636 (holding that discretionary withdrawals of corporate funds by shareholder-officer for his own use were constructive dividends, not loans, because withdrawal privileges were unrestricted and there was neither documentation nor intent to repay at time of advance). *But see Martin v. Commissioner*, T.C. Memo 1997-492 (rejecting IRS's argument that *Crowley* required unpaid funds transferred from corporation to friend of 50% shareholder to be treated as constructive dividends because, in *Crowley*, taxpayer used corporate funds but here petitioner did not use unpaid loan balance, and in *Crowley* taxpayer did not intend to repay funds whereas here petitioner and corporation expected friend to repay loans).

[200] *Alterman Foods, Inc. v. United States*, 505 F.2d 873 (5th Cir. 1974), *aff'g* 73-2 USTC ¶9792 (N.D. Ga. 1973); *Livernois Trust v. Commissioner*, 433 F.2d 879 (6th Cir. 1970), *aff'g* T.C. Memo 1969-111; *Estate of Chism v. Commissioner*, 322 F.2d 956 (9th Cir. 1963), *aff'g* T.C. Memo 1962-6; *Oyster Shell Prods. Corp. v. Commissioner*, 313 F.2d 449 (2d Cir. 1963), *aff'g* T.C. Memo 1961-323; *Shea v. United States*, 83-1 USTC ¶9115 (N.D. Ala. 1982); *Kaplan v. Commissioner*, 43 T.C. 580 (1965); *Roschuni v. Commissioner*, 29 T.C. 1193 (1958), *aff'd per curiam*, 271 F.2d 267 (5th Cir. 1959). *See also Illinois Tool Works Inc.*, T.C. Memo 2018-121 (citing many of the above factors in addition to considering whether the shareholder had the ability to borrow from third parties on similar economic terms).

[201] 109 F.3d 56 (1st Cir. 1997).

[202] 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2.

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holder; and (5) the corporation's deficit in earnings and profits for the years at issue.

In *Miller v. Commissioner*,[203] a shareholder's wholly owned corporation made advances to the shareholder over a period of three years. The Tax Court compared the factors indicating the existence of a bona fide debt represented by the advances with those indicating the existence of a constructive dividend and held that the advances were loans. The court noted that the following factors indicated debt: the shareholder executed demand notes for all of the net transfers during the three years at issue; the shareholder repaid a portion of the total transfers during the three years at issue, and the remaining balance was repaid within the next five years; and the net transfers were treated as taxable loans receivable on the corporation's state personal property tax return for one of the tax years at issue. The following factors indicated a constructive dividend: the shareholder did not pay any interest to the corporation with respect to the transfers, and the demand notes did not provide for interest; no security was given to the corporation for the transfers; the shareholder controlled the corporation; there was no documented limitation on the amount of net transfers outstanding at any particular time; and, during the years at issue, the corporation paid no formal dividends or wages.

In *Shea v. United States*,[204] however, the court looked also to subjective factors to determine intent. In *Shea*, the court held that advances in the form of loans made by a corporation to a 50% shareholder, reflected on the corporate books as accounts receivable and represented as such on financial statements prepared for the corporation and later provided to banks and bonding companies, were loans. The court found that, although no numerical limit or ceiling was imposed on the amount that could be advanced, the other 50% shareholder's approval was required, thus imposing a de facto ceiling. In addition, the corporation's articles of incorporation provided that it was to have a lien on its shares of stock for any debt or liability owed to it by a shareholder. Moreover, systematic repayments were being made through payroll deductions at a rate that would have resulted in repayment of the advances within a few years. The court noted that no interest was charged on the advances because the corporation had a policy, applicable equally to all employees, not to charge interest on advances by the corporation. Finally, the court found that there was no need on the part of the corporation to force repayment, and that the advances were not large and the larger amounts were advanced to cover pressing family medical needs. As in *Pierce*, the amounts advanced to the shareholder were not the same as those advanced to the other 50% shareholder. Although there was no set maturity date for repayment of the withdrawals, both shareholders testified that the advances were to be repaid within a reasonable time. The court stated:

> The subjective intent of the parties is not to be totally disregarded. *Alterman Foods* … stands for the proposition that objective criteria will control over the mere declarations of intent by the party seeking to maximize his tax benefit, especially in cases involving sole shareholders. It does not hold, however, that the subjective intent of the parties cannot be considered.

[203] T.C. Memo 1980-445.

[204] 83-1 USTC ¶9115 (N.D. Ala. 1982).

The court found that the subjective intent of the parties was to repay the advances.

In *Smith v. Commissioner*,[205] the Tax Court held that distributions made by a corporation to its president, a 50% shareholder, were dividends includible in gross income, not loans. The court relied on the facts that: (1) the transfers (representing payment for furniture purchased for the shareholder's personal use, taxes for which he was personally liable, payment for a truck used by him, and payment for an airline ticket for one of his relatives), which were treated as loans in the accounts receivable account, were not consistently recorded as loans on the other books and records of the corporation; (2) the balance sheets filed with the corporation's income tax returns showed no amounts listed as "Loans to Stockholders;" (3) the shareholder did not repay any portion of the advances; and (4) the shareholder executed no notes with respect to his withdrawals, he neither agreed to nor paid any interest, and no collateral was ever pledged to secure the debt. The court noted that the corporation had received notes for its loans to the shareholder's children. The corporation also had executed an interest-bearing note for a loan the shareholder made to it.

Although none of the factors alone requires a finding of a constructive dividend or a bona fide debt,[206] some factors seem to favor a determination that a constructive dividend was made and others tend to favor a finding that a loan was made.

Unfettered control of a corporation by a shareholder, for example, tends to support a finding that amounts advanced to the shareholder by the corporation are constructive dividends. Conversely, if a 50% shareholder must obtain the approval of other shareholders, a finding that the shareholder controls the corporation is less likely.[207] In *Thielking v. Commissioner*,[208] the court found that the taxpayer controlled his corporation and held that he was liable for additional taxes attributable to advances determined to be constructive dividends. The taxpayer was the sole director and president of the corporation and its de facto sole shareholder; the other shareholder was an employee stock ownership trust of which he was the sole beneficiary.

A finding that a corporation has a deficit in earnings and profits, or a history of dividend payments, supports a determination that advances made to a shareholder are bona fide loans.[209] Conversely, a corporate history of not declaring and paying dividends even when there are substantial earnings and profits indicates a constructive dividend.[210]

A limit on the amount that a corporation may advance to its shareholders favors a determination that the advances are

[205] T.C. Memo 1980-15.

[206] *Pierce v. Commissioner*, 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2; *White v. Commissioner*, 17 T.C. 1562 (1952), *acq.*, 1952-2 C.B. 1; *Smith v. Commissioner*, T.C. Memo 1980-15. *See also Lewis v. Commissioner*, T.C. Memo 1985-563.

[207] *See Shea v. United States*, 83-1 USTC ¶9115 (N.D. Ala. 1982). *See also Pierce v. Commissioner*, 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2.

[208] T.C. Memo 1987-227.

[209] *See Pierce v. Commissioner*, 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2; *Haber v. Commissioner*, 52 T.C. 255 (1969), *aff'd per curiam*, 422 F.2d 198 (5th Cir. 1970); *Shaken v. Commissioner*, 21 T.C. 785 (1954).

[210] *Thielking v. Commissioner*, T.C. Memo 1987-227. *See also Busch v. Commissioner*, T.C. Memo 1983-98, *aff'd*, 728 F.2d 945 (7th Cir. 1984).

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loans, not constructive dividends. Even if no numerical limit or ceiling is imposed, a de facto ceiling may exist if the approval of another shareholder is required for the authorization of advances.[211]

In contrast, the fact that no security is given for an advance indicates that a distribution or transfer is a constructive dividend.[212] This factor may carry more weight in situations in which the shareholder uses the advances to purchase property. In *Lewis v. Commissioner*,[213] for example, the shareholders used advances made by their wholly owned corporation to purchase, on their own behalf, a 12-unit apartment complex, a residence, and stock and other investments. The court held that such advances were dividends, noting in particular that there were no formal indicia of debt and that neither security agreements were entered into with respect to the advances, nor were security interests ever granted to the corporation in any of the property acquired with the advances. In contrast, in *Pierce v. Commissioner*,[214] in which the court held that advances to the shareholders were loans, the shareholder signed a two-year non-interest-bearing note for the aggregate sum that he owed his corporation, secured by stock that he owned in another corporation. Under certain circumstances, however, the lack of collateral or security is not a factor indicating a constructive dividend. For example, in *Shea v. United States*,[215] in which the articles of incorporation gave the corporation a lien on its shares of stock for any debt or liability incurred to it by a stockholder, the fact that no security was given for advances to a shareholder did not preclude a finding that the advances were bona fide loans.

Practice Point: The court indicated that this is the result even if the shareholders are unaware of the provision in the articles of incorporation when the advances were made; the corporation still had a lien on the stock.

Attempts by the shareholder to repay the corporation tend to support a determination that the advances are loans.[216] In *Thielking v. Commissioner*,[217] however, when the shareholder relied on repayments as evidence of his intention to repay, the court noted that the repayments did not reduce the net balance due and that the balance due actually increased. It also noted that, contrary to the shareholder's assertions, the repayments were not all in cash and many were credits toward the withdrawals, e.g., a reduction of the net balance by the bonus to the shareholder declared by the corporation, by the shareholder's personal accounts receivable that were collected by the corporation, and by the proceeds from the sale of the shareholder's vehicle. The court did not explain its reasoning, but, citing *Baird v. Commissioner*[218] and *Meyer v. Commissioner*,[219] merely stated, "Under these circumstances, we do not believe that the repayments and credits are persuasive evidence that the withdrawals were bona fide debts of Dr. Thielking."[220]

Practice Point: That the repayments are not all in cash, but some consist of credits toward the withdrawals, is immaterial. A repayment is no less so by virtue of its being made in property, in the form of an offset, or in any form other than cash. Compare *Pierce v. Commissioner*,[221] in which the shareholder made substantial repayments to his corporation for advances made to him over a period of six years, by transferring to the corporation stock in a franchise he owned. In a different transaction, the shareholder transferred to the corporation his interest in a house, subject to a deed of trust. On another occasion, the shareholder repaid advances by conveying shares of stock to the corporation. The Tax Court considered these transfers valid repayments of the amounts owed to the corporation by the shareholder.

The fact that no maturity date is set for the repayment of advances does not prevent a finding that the advances were bona fide loans if the expectation of the parties is that the advances will be repaid within a reasonable time and if payments that would allow for the advances to be repaid within a reasonable time are in fact made.[222] Similarly, the failure of a corporation to force repayment does not necessarily prevent advances from being treated as loans if systematic payments are being made.[223]

In determining whether a shareholder is in a position to repay advances, evidence of the shareholder's income, including salary paid by the corporation, and of the shareholder's net worth when the advances are made is relevant.[224] However, a shareholder's credit standing generally is not conclusive evidence of the shareholder's ability to repay.[225]

The failure to pay interest to a corporation on transfers to the shareholder supports the finding of a dividend.[226] The failure to pay interest is not overcome by a journal entry made on the books of the corporation reflecting accrued interest on net with-

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[211] *Shea v. United States*, 83-1 USTC ¶9115 (N.D. Ala. 1982).

[212] *Miller v. Commissioner*, T.C. Memo 1980-445; *Smith v. Commissioner*, T.C. Memo 1980-15. *Compare McGee v. Commissioner*, T.C. Memo 1991-599, in which the Tax Court found that withdrawals from a closely held corporation by a shareholder were bona fide loans even though there was no security or interest and notes were not issued for all of the transactions. According to the court, these facts are not uncommon in dealings between a shareholder and a closely held corporation. The court observed that the borrower intended to, and eventually did, fully repay the loans. The court also noted that the advances were recorded on corporate books and records as well as on the corporate financial statements, the borrower executed several notes, and the loans were not in proportion to the stock ownership or profits of the corporation.

[213] T.C. Memo 1985-563.

[214] 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2.

[215] 83-1 USTC ¶9115 (N.D. Ala. 1982).

[216] *Pierce v. Commissioner*, 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2; *Miller v. Commissioner*, T.C. Memo 1980-445; *In re Betpouey*, 98-2 USTC ¶50,745 (Bankr. E.D. La. 1998) (advances were loans in situation in which taxpayer was financially able to repay advances and attempted to do so).

[217] T.C. Memo 1987-227.

[218] 25 T.C. 387 (1955).

[219] 45 B.T.A. 228, 240 (1941), *acq.*, 1942-1 C.B. 12.

[220] T.C. Memo 1987-227.

[221] 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2.

[222] *Pierce v. Commissioner*, 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2. *See also Tahamtan v. Commissioner*, T.C. Memo 1995-226 (amounts borrowed from corporations by sole shareholder and not repaid were constructive dividends where there was no evidence that the purported loans had a fixed maturity date or that the shareholder had any intention of repaying them).

[223] *Pierce v. Commissioner*, 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2.

[224] *Pierce v. Commissioner*, 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2.

[225] *See, e.g., Smith v. Commissioner*, T.C. Memo 1980-15 (shareholder's credit standing was disregarded when other evidence established that his house was mortgaged to secure indeterminate amount of corporate debt and that corporation and shareholder were so cash poor that shareholder had to cash in life insurance to keep corporation's account from being overdrawn). *See also Roschuni v. Commissioner*, 29 T.C. 1193 (1958), *aff'd per curiam*, 271 F.2d 267 (5th Cir. 1959); *Baird v. Commissioner*, 25 T.C. 387 (1955).

[226] *Miller v. Commissioner*, T.C. Memo 1980-445.

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drawals made by the shareholder with a corresponding credit to the corporation's interest income, if the shareholder makes no actual interest payments.[227] However, the fact that the corporation charges no interest does not preclude a finding that advances are bona fide loans if the corporation has a policy, applied to all employees, not to charge interest.[228]

Practice Point: With regard to forgone interest on any below-market loan that is a demand loan directly or indirectly between a corporation and any shareholder of such corporation, the amount of money treated as transferred by the lender to the borrower is a distribution of money characterized according to §301 or, in the case of an S corporation, according to §1368, if the corporation is the lender.[229] Section 7872(c)(3) provides a de minimis exception for corporate-shareholder loans. Under the de minimis exception, these rules do not apply to loans between a shareholder and his corporation aggregating no more than $10,000 on any given day. The de minimis exception does not apply, however, to any loan the interest arrangement of which has as one of its principal purposes the avoidance of any federal tax.[230]

Courts generally take into account evidence of the manner in which a corporation has accounted for advances to its shareholders. For example, courts usually look for some indication that the corporation has treated the advances as loans on its financial statements and books.[231] If the corporation has failed to do so (because, for example, no notes were executed by the shareholder with respect to the withdrawals), the courts may view the corporation's failure and the lack of a certificate of indebtedness or promissory note as indicia of a dividend.[232] The corporation's accounting of the withdrawals as loans on its books and records may indicate that it intends to repay the advances but is not determinative without further evidence of a bona fide loan.[233]

An agreement between the corporation and a shareholder that imposes an absolute and unconditional obligation on the shareholder to repay indicates the existence of a bona fide debt. In *Alterman Foods, Inc. v. United States*,[234] the court considered the terms of an agreement that failed to provide an absolute duty to repay. It appeared, according to the court, that the debt was payable at the discretion of the debtor. The shareholder was obligated to account for the advances that it had received at a time mutually agreed upon by the shareholder and the corporation. The court found that this promise of the shareholder to account for its debts only if the parties should so agree was illusory, and held that the advances were constructive dividends.

The courts sometimes have considered, as a factor, whether the advances made to a shareholder are proportionate to the shareholder's stock ownership. In *Pierce v. Commissioner*[235] and *Shea v. United States*,[236] the courts noted that the loans made to the taxpayer, a 50% shareholder, far exceeded loans made to the other 50% shareholder and held that the taxpayer advances should be considered as loans and not dividends. In contrast, in *Thielking v. Commissioner*[237] the court determined that advances to the shareholder that were not in proportion to his shareholdings were constructive dividends. The court stated:

> It is well settled that the disbursement of corporation earnings to a shareholder may constitute a dividend to such shareholder notwithstanding that it is not in proportion to stockholdings or that some shareholders do not participate in its benefits. This principle is especially true where the record fails to disclose that the nonparticipating shareholders complained of such distributions … . Here, there is no evidence that the nonparticipating shareholder, i.e., the trustee, complained of the distributions.[238]

A pattern of advances that are subsequently reduced may indicate the presence of constructive dividends. In *Bruecher v. Commissioner*,[239] the sole shareholder of his corporation used the corporation's bank account to pay personal expenses. The expenses were treated as advances and then, in part, reclassified as wages. Subsequently, the amount of advances increased again. The court found the advances to constitute constructive dividends. Notably, the corporation did not have a history of paying dividends or salary to the sole shareholder, the advances were not memorialized by written notes nor did they have a repayment schedule, nor was collateral given with respect thereto or interest paid thereon.

Section 385 authorizes the Treasury Department to prescribe regulations to determine whether an interest in a corporation is to be treated as equity or debt (or as in part equity and in part debt). On May 14, 2020, the IRS finalized regulations that recharacterize certain debt instruments issued by a corporation to a shareholder as stock for federal income tax purposes.[240] The regulations treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes.[241] If the instrument is recharacterized as equity under the regulations, any payments made on the instrument

[227] *Thielking v. Commissioner*, T.C. Memo 1987-227.

[228] *Shea v. United States*, 83-1 USTC ¶9115 (N.D. Ala. 1982).

[229] Prop. Reg. §1.7872-4(d), §1.7872-4(g).

[230] §7872(c)(3)(B).

[231] *Shea v. United States*, 83-1 USTC ¶9115 (N.D. Ala. 1982); *Smith v. Commissioner*, T.C. Memo 1980-15 (balance sheet reflecting nothing under "Loans to stockholders" indicated advances were constructive dividends).

[232] *Smith v. Commissioner*, T.C. Memo 1980-15.

[233] *Baird v. Commissioner*, 25 T.C. 387, 395 (1955); *Meyer v. Commissioner*, 45 B.T.A. 228, 239 (1941), *acq.*, 1942-1 C.B. 12; *Thielking v. Commissioner*, T.C. Memo 1987-227.

[234] 505 F.2d 873 (5th Cir. 1974), *aff'g* 73-2 USTC ¶9792 (N.D. Ga. 1973).

[235] 61 T.C. 424 (1974), *acq. in result*, 1976-2 C.B. 2.

[236] 83-1 USTC ¶9115 (N.D. Ala. 1982).

[237] T.C. Memo 1987-227.

[238] T.C. Memo 1987-227.

[239] T.C. Summary Opinion 2005-52.

[240] *See* T.D. 9897, 85 Fed. Reg. 28,867 (May 14, 2020). The regulations finalized 2016 final, temporary, and proposed regulations without substantive change. REG-130314-16, 81 Fed. Reg. 72,751 (Oct. 21, 2016). Note that, in addition to the recharacterization rules, the 2016 regulations also contained certain documentation rules that were required to be satisfied to avoid recharacterization of a related-party debt instrument as equity. However, in 2019, T.D. 9880, 84 Fed. Reg. 59,297 (Nov. 4, 2019), removed the documentation regulations of Reg. §1.385-2 before they became applicable.

[241] Reg. §1.385-3, §1.385-4. Generally, these regulations apply to purported debt between members of an expanded group, which is defined using the §1504(a) affiliated group tests with certain modifications. However, these regulations generally do not apply to S corporations, REITs, RICs, and certain regulated financial institutions and insurance companies. The IRS announced in T.D. 9897 that it intends to study and issue proposed regulations modifying the recharacterization regulations.

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would be considered constructive distributions and not as interest.

Under the recharacterization rules of Reg. §1.385-3, a covered debt instrument[242] is recharacterized as equity in the event of: (1) distribution of the debt instrument to a related corporate shareholder; (2) exchange of the debt instrument for affiliate stock; (3) issuance of the debt instrument by an acquiring corporation in an internal asset reorganization;[243] or (4) issuance of the debt instrument with a principal purpose of funding any of the above three transactions.[244] The regulations generally apply to tax years ending on or after January 19, 2017, for debt instruments issued after April 4, 2016.[245]

For a more detailed discussion of the §385 regulations, see 702 T.M., *Capitalizing a Business Entity: Debt vs. Equity*.

(2) Loans to Corporations

When a corporation transfers money to its shareholder in partial or complete repayment of a loan, the transaction is scrutinized to determine whether the amounts transferred are, in fact, loan repayments or are, instead, a constructive dividend to the shareholder.[246] The question of whether amounts paid by a corporation to its shareholder are repayments of a loan by the shareholder to the corporation is one of fact.[247]

The many indicia that advances by the shareholder to the corporation are bona fide debt include:

(1) notations on the books and records of the corporation or on checks characterizing the advances as loans;

(2) characterization of the advances as loans on the corporation's income tax returns;

(3) repayments by the corporation;

(4) existence of promissory notes or certificates of indebtedness;

(5) subjective intent of the shareholders; and

(6) payment of interest.[248]

No single one of these factors is determinative. In *Adrey v. Commissioner*,[249] the corporation's two 50% shareholders made proportionate advances to a corporation. The advances were credited to the corporation's capital surplus account and were not evidenced by notes. No interest payments were made on the advances, and no repayment time was set. The advances were held to be loans. The court relied on one of the shareholder's designation of the advances on his checkbook stubs as "loans," even though the cancelled checks had been destroyed.

Many of the cases analyzing whether advances made by a corporation to a controlling shareholder, seemingly as a loan repayment, are constructive dividends also involve whether the original advances by the shareholder to the corporation were contributions to the corporation's capital,[250] whether a purported debt instrument represents debt or equity, or whether the corporation is adequately capitalized. Although these issues are beyond the scope of this analysis,[251] some of the criteria relevant to determining whether advances made by a shareholder to a controlled corporation are contributions to capital, or whether a purported debt instrument is, in fact, equity or stock, are also relevant in determining the character of a corporation's transfers to a shareholder, namely: (1) an obligation on the corporation's part to pay the shareholder; (2) a fixed maturity date; (3) repayments by the corporation; (4) the corporation's payment, or agreement to pay, interest; (5) whether security was provided to the shareholder; and (6) the corporation's dividend-payment record.[252] These factors have been applied in ascertaining whether transfers by a corporation to its shareholders are bona fide loans.

b. Transactions Characterized as Sale of Property Between Shareholder and Corporation

(1) Transactions Characterized as Sale of Property by Shareholder to Corporation

In determining whether payments made by a corporation to a shareholder are made, in substance, with respect to the corporation's stock and, therefore, are dividends, the characterization of the payment as consideration for the sale of property is not controlling.[253] The constructive-dividend theory applies in cases involving the sale of property between a closely held corporation and one or more of its shareholders to prevent the shareholders from siphoning off corporate profits under the guise of a sales transaction. The transaction is placed on a tax parity with arm's-length dealings between unrelated parties.[254] The reasoning underlying the placement of a sales transaction between a closely held corporation and its shareholders on a tax parity with an arm's-length transaction is that transactions

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[242] A covered debt instrument is very basically a debt instrument issued by a covered member (a domestic corporation that is a member of an expanded group). Reg. §1.385-3(g)(3). Reg. §1.385-3 requires that the covered debt instrument also be "issued by a covered member to a member of the covered member's expanded group."

[243] See the "general rule" of Reg. §1.385-3(b)(2).

[244] See the "funding rule" of Reg. §1.385-3(b)(3).

[245] Reg. §1.385-1(f).

[246] *See, e.g., Charles O. Finley & Co. v. Commissioner*, T.C. Memo 1982-354. The issue has arisen in cases involving the question of whether amounts diverted from a corporation are dividends or the repayment of a loan (or a return of capital). *See United States v. D'Agostino*, 145 F.3d 69 (2d Cir. 1998) (sole shareholder of corporation not liable for income tax evasion under §7201 for diverting funds from corporation because corporation had no earnings and profits and owed money to shareholder); *DiZenzo v. Commissioner*, 348 F.2d 122 (2d Cir. 1965) (funds diverted by shareholder are taxable income only to extent of earnings and profits); *Truesdell v. Commissioner*, 89 T.C. 1280 (1987), *acq.*, 1988-2 C.B. 1 (amounts treated as constructive dividends and taxed to extent of earnings and profits). *Compare United States v. Williams*, 875 F.2d 846 (11th Cir. 1989), and *Davis v. United States*, 226 F.2d 331 (6th Cir. 1955), which held that the government need not characterize diverted funds and need not prove that diverted funds are constructive dividends or that the corporation had any earnings and profits.

[247] *See Bane v. Campbell*, 53-2 USTC ¶9564 (N.D. Tex. 1953). *See also Beckley v. Commissioner*, 130 T.C. 325 (2008) (Tax Court declined to hold that unwritten obligation could not be debt simply because it violated state statute of frauds; court examined loan repayment character of payments for federal tax purposes and concluded that they represented bona fide debt).

[248] *Charles O. Finley & Co., Inc. v. Commissioner*, T.C. Memo 1982-354.

[249] T.C. Memo 1957-90.

[250] *See Charles O. Finley & Co., Inc. v. Commissioner*, T.C. Memo 1982-354, and cases cited therein.

[251] See 538 T.M., *Bad Debts*, for a discussion of these issues.

[252] *See, e.g., Charles O. Finley & Co. v. Commissioner*, T.C. Memo 1982-354.

[253] *See S. Ford Tractor Corp. v. Commissioner*, 29 T.C. 833 (1958), *acq.*, 1958-2 C.B. 7; *Stuchell v. Commissioner*, T.C. Memo 1978-236.

[254] *See Champayne v. Commissioner*, 26 T.C. 634 (1956), *acq.*, 1958-2 C.B. 4; *Stuchell v. Commissioner*, T.C. Memo 1978-236.

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between unrelated parties, absent any evidence to the contrary, are presumed fair and are accorded full recognition for tax purposes.[255]

In testing a sale of property between a closely held corporation and its shareholders against the arm's-length standard, it is sometimes necessary to determine the fair market value of the property.[256] "Fair market value" is defined as the price at which a willing buyer and a willing seller would arrive if neither is under a compulsion to buy or sell.[257] This is a factual issue.[258] However, if the evidence establishes that the transaction was bona fide and conducted in an arm's-length manner, it is unnecessary to determine independently the value of the property sold.[259]

In *Bardahl v. Commissioner*,[260] the controlling shareholders of a corporation sold their personal residence to their corporation in exchange for its assumption of a mortgage and an interest-bearing demand note. The Tax Court upheld the IRS's determination that the shareholders had received a dividend because the amount paid by the corporation for the house exceeded the house's fair market value at the date of sale. The amount of the dividend equaled the difference between the amount paid by the corporation for the shareholders' residence and the fair market value of the residence.

Evidence that the shareholder paid substantially less for property that the shareholder then sold to a controlled corporation shortly after the purchase is relevant in determining if the gain realized by the shareholder on the sale to the corporation is a constructive dividend. In *Goldstein v. Commissioner*,[261] the controlling shareholder of a corporation acquired real estate, on which the corporation held a favorable long-term lease and on which it operated a retail grocery business, subject to the lease held by the corporation, in exchange for property worth $35,000. Less than a month after the exchange, the shareholder conveyed the real estate to the corporation for $75,000 in cash, thus receiving $40,000 in excess of its cost. The Tax Court held that the shareholder's profit on the sale represented a distribution of corporate earnings. It found that the corporation would not have paid $75,000 for the property to an outsider, and observed that the shareholder, who was also the corporation's president, had refused to pay more than $35,000 for the property, when negotiating on behalf of the corporation, on the grounds that the lease still had 42 years to run at an annual rental of $800.

If the corporation receives consideration equal to or greater than the value of the property distributed, no constructive dividend results because the corporate net worth has not diminished.[262] Evidence that the shareholder has undertaken to determine the fair market value of property sold to a controlled corporation is relevant in determining whether a dividend results. Thus, in *Miles Production Co. v. Commissioner*,[263] the court held that a shareholder's sale of his interest in a certain agreement and mineral leases to his wholly owned corporation, at a price equal to the minimum value of the property, did not result in a constructive dividend to the shareholder. The court stated:

> This is not a case of an individual taxpayer selling properties to a wholly owned corporation at an arbitrary price and then seeking to justify that price when subsequently challenged by the Internal Revenue Service. This is a situation where an individual taxpayer, after being advised not to sell the properties for a price in excess of fair market value, determined the minimum value of the properties and, after having that value confirmed by the independent valuation report of the first [sic] National Bank, sold them for that price. [The shareholder] took every precaution to prevent a dividend.[264]

Comment: A shareholder intending to sell property to the shareholder's controlled corporations is well advised to obtain an appraisal of the property by an independent, qualified third party appraiser, and to sell the property to the corporation for an amount not exceeding the appraised value of the property.

If the stock of a corporation is held by a small group of people, it is often considered necessary to the continuity of the corporation to have the individuals enter into agreements among themselves to provide for the disposition of the stock of the corporation in the event of the resignation, retirement, disability, death, etc., of one of the shareholders. These agreements typically provide that upon the departure of one of the principal shareholders, the remaining shareholders will purchase that shareholder's stock. The agreements usually are assigned to the corporation by the remaining shareholders, and the corporation redeems its stock from the retiring shareholder.

In Rev. Rul. 69-608,[265] the IRS addressed corporate redemptions of a retiring shareholder's stock when the remaining shareholder had entered into a contract to purchase such stock. The IRS ruled that, when a corporation redeems stock from a retiring shareholder, no constructive dividend results to the continuing shareholder from the corporation's satisfaction of the continuing shareholder's executory contractual obligation to purchase the redeemed shares, provided that the continuing shareholder is not subject to an existing primary and unconditional obligation to perform the contract and that the corporation pays no more than fair market value for the stock redeemed. However, a constructive dividend does result if the continuing shareholder, at the time of assignment to the cor-

[255] *See Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954); *Stuchell v. Commissioner*, T.C. Memo 1978-236.

[256] *See Goldstein v. Commissioner*, 298 F.2d 562 (9th Cir. 1962), *aff'g* T.C. Memo 1960-276; *Honigman v. Commissioner*, 55 T.C. 1067 (1971), *aff'd in part and rev'd in part*, 466 F.2d 69 (6th Cir. 1972); *Stuchell v. Commissioner*, T.C. Memo 1978-236.

[257] *See Bardahl v. Commissioner*, T.C. Memo 1965-116.

[258] *Bardahl*, T.C. Memo 1965-116.

[259] *See Brown Printing Co. v. Commissioner*, 255 F.2d 436 (5th Cir. 1958), *rev'g* T.C. Memo 1957-37; *Place v. Commissioner*, 17 T.C. 199 (1951), *aff'd per curiam*, 199 F.2d 373 (6th Cir. 1952), *acq.*, 1951-2 C.B. 3; *Stuchell v. Commissioner*, T.C. Memo 1978-236.

[260] T.C. Memo 1965-116.

[261] T.C. Memo 1960-276, *aff'd*, 298 F.2d 562 (9th Cir. 1962).

[262] *Miles Prod. Co. v. Commissioner*, T.C. Memo 1969-274, *aff'd*, 457 F.2d 1150 (5th Cir. 1972).

[263] T.C. Memo 1969-274, *aff'd*, 457 F.2d 1150 (5th Cir. 1972).

[264] T.C. Memo 1969-274.

[265] *See also* PLR 200939011 (provided redemption of corporation stock held by taxpayer and his son is not performed in satisfaction of primary and unconditional obligation of nonredeemed shareholder to acquire corporation stock held by said shareholders, redemption will not cause any dividend income to be realized or constructively received by any nonredeemed shareholder *citing Holsey v. Commissioner*, 258 F.2d 865 (3d Cir. 1958) *acq.*, Rev. Rul. 58-614).

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poration of the shareholder's contract to purchase the retiring shareholder's stock, is subject to an unconditional obligation to purchase the retiring shareholder's stock.

Although a pre-existing obligation to perform in the future is a necessary element in establishing a constructive dividend in this case, the IRS ruled that it is not until the obligor's duty to perform becomes unconditional that a primary and unconditional obligation results.

In Rev. Rul. 69-608, the IRS set forth seven examples of stock redemptions that raise the issue of a constructive dividend. The ruling contrasts certain situations in which the continuing shareholder, at the time of the assignment of the purchase contract to the corporation, is subject to an unconditional obligation to buy with situations in which, at the time of the assignment, the continuing shareholder has not yet incurred a primary and unconditional obligation to pay for the stock.

TAM 9401001, involving two groups of shareholders of the same corporation (X), cited Rev. Rul. 69-608. The issue in TAM 9401001 was whether the first group of shareholders received a constructive dividend for an amount paid by a new corporation (N) for the purchase of the shares of the second group. Part of the transaction involved the merger of X with N and the granting of a security interest and mortgage to a bank on all of N's assets. The National Office advised that the first group of X shareholders were acting as agents of N and had no plan or intention to own the shares of X sold by the second group or to personally repay the loan proceeds used to acquire that stock. Therefore, there was no constructive dividend.

Comment: TAM 9401001 appears to be a relaxation of a previous IRS position to the extent that it accepted the first group of X shareholders' oral representation that they acted as agents for N, despite the fact that the second group of shareholders was unaware of that fact and the original loan commitment contemplated that the first group would purchase the second group's stock. The IRS formerly had required a written assignment in such circumstances.

Rev. Rul. 69-608 was also cited in *Arnes v. Commissioner* ("*Arnes II*"),[266] in which the taxpayer's (T's) former spouse (W) had her shares redeemed by the couple's corporation (C), pursuant to a divorce decree. Under the decree, T guaranteed C's obligation to pay W upon redemption of her stock. The court determined that T had, at most, a secondary obligation, which could mature only on C's default on its primary obligation, to purchase W's stock. The court stated that the situation was analogous to Situation 5 of Rev. Rul. 69-608, in which the IRS ruled that a shareholder was only secondarily liable to purchase a deceased shareholder's stock under an agreement requiring the shareholder to purchase the deceased shareholder's stock only if the corporation did not redeem the stock. The court held that no constructive dividend resulted to T from C's redemption of W's stock because T did not have a primary and unconditional obligation to purchase W's stock.

Comment: The decision in *Arnes II* is notable in that it resulted in the IRS's being whipsawed. In an earlier case involving W ("*Arnes I*"),[267] the IRS had determined that W's transfer of shares to C was a taxable redemption resulting in gain to W. However, the Ninth Circuit disagreed and found that the redemption was required by a divorce instrument and was a nontaxable transfer under §1041. According to the court, the transfer benefited T because it settled any future property claims that W could assert against him. The IRS used this decision to argue that, under *Golsen v. Commissioner*,[268] the decision in *Arnes I* controlled the decision in *Arnes II* and that T received a constructive dividend from C. The Tax Court, however, held that *Golsen* did not apply because *Arnes I* did not address the legal issue involved in *Arnes II*: whether there was a constructive dividend to T. As a result of the two decisions, neither T nor W was taxed on $450,000 taken out of C.

In *Praegitzer v. Commissioner*,[269] the Tax Court held that *Arnes I* was not applicable and a constructive dividend resulted when the taxpayer's corporation forgave debt and made a cash distribution to him. The cash distribution occurred after the completion of a reorganization, which was incident to a divorce and in which the taxpayer relinquished his stock in a corporation he had previously owned with his former wife. The court found that any further transactions between the taxpayer and his solely owned corporation should be taxed according to general principles of taxation. Stock transfers incident to divorce are discussed more fully in 515 T.M., *Divorce and Separation*.

(2) *Transactions Characterized as Sale of Property by Corporation to Shareholder*

Although a sale of corporate assets by a corporation to its shareholder is, literally, a distribution of the corporation's property to the shareholder, it is not necessarily a dividend. An arm's-length sale of property by a corporation to its shareholder does not diminish the corporation's net worth and, therefore, cannot result in any distribution of the corporation's profits.[270] Conversely, a sale of property for less than fair market value may be an effective means of distributing profits to the shareholders.[271] Thus, a sale of property to a controlling shareholder at less than fair market value generally results in a constructive dividend to the shareholder if the transaction, in purpose or effect, achieves a distribution of corporate earnings.[272] This is true even if title is transferred to the shareholders and their spouses, who are not shareholders of the corporation, as tenants by the entirety.[273] In other words, if corporate property is sold to a shareholder for less than its fair market value, the transaction is a bargain purchase; the "bargain" element generally measures the amount of the constructive dividend to the shareholder.[274] This can be a useful way to distribute the earnings and profits of a corporation without having to distribute cash. For example, the shareholders could be anticipating a dividend rate increase

[266] 102 T.C. 522 (1994). *See also Read v. Commissioner*, 114 T.C. 14 (2000) (no gain recognized by wife, but court indicated husband would receive constructive dividend).

[267] *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992).

[268] 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

[269] T.C. Memo 1997-79.

[270] *Palmer v. Commissioner*, 302 U.S. 63 (1937).

[271] *See Palmer v. Commissioner*, 302 U.S. 63 (1937).

[272] *See Palmer v. Commissioner*, 302 U.S. 63 (1937).

[273] *Fausek v. United States*, 81-1 USTC ¶9243 (E.D. Mo. 1981) (at shareholders' direction, title transferred to shareholders and their non-shareholder wives as tenants by the entirety; constructive dividend found).

[274] *Cent. Oil Co. v. United States*, 71-1 USTC ¶9257 (S.D. Miss. 1970) (excess of fair market value over amount paid for property held constructive dividend); *Miller v. Commissioner*, T.C. Memo 1977-39 (same). *See also S. Ford Tractor Corp. v. Commissioner*, 29 T.C. 833 (1958), *acq.*, 1958-2 C.B. 7.

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in the following year and want to eliminate accumulated earnings and profits.

A showing by the shareholder that the fair market value of the property purchased from the corporation is equal to the price paid negates constructive-dividend characterization.[275] Whether a sale of property by a corporation effects a constructive dividend is a factual determination.[276]

In *Estate of Durkin v. Commissioner*,[277] the Tax Court stated, in a reviewed opinion, that the taxpayers could not recast as a redemption a transaction that they had structured as a sale, and held that the taxpayers received a constructive dividend from their bargain sale. The taxpayers sold their stock to the corporation at a price equal to basis and simultaneously purchased property from the corporation at a bargain price. The Tax Court noted that the rule binding taxpayers to the form of their transaction is not absolute, but cited several decisions in which the Tax Court held that a taxpayer must have strong proof to disavow the structure of a transaction.

Comment: As in the case of transactions characterized as sales of property by shareholders to their corporations, the main objective in avoiding constructive-dividend treatment for a transaction characterized as a sale of property by the corporation to the shareholder is demonstrating that the transaction is similar to a transaction at arm's length between unrelated parties. The best means of making this showing is evidence that the property changed hands upon payment of fair market value.

In FSA 199905007, the Chief Counsel's Office concluded that a subsidiary's (S's) sale of assets to its parent (P) was, in substance, a dividend distribution. The sale of assets by S to P was made pursuant to P's plan to sell S to an unrelated buyer (B) who objected to purchasing certain assets held by S. State law prevented S from making an outright distribution of the unwanted assets. The purchase agreement between P and B provided that S would sell its unwanted assets to P and P would sell its S stock to B. The set purchase price for S equaled the value of the S stock without the unwanted assets plus the excess purchase price of the unwanted assets purchased by P.

Practice Point: In addition to resulting in a constructive dividend, a bargain sale from a corporation to a shareholder also results in a recognition of gain based on the fair market value of property sold rather than the consideration received from the shareholder. Therefore, significant adjustments in the value of the property can result in a meaningful corporate level tax.

(3) Determining the Fair Market Value of Property

As noted in IV.F.1.b.(1), above, "fair market value" has been defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.[278] The fair market value of property is based upon the "highest and best use" of the property as of its relevant valuation date.[279] The determination of the fair market value of property is a question of fact that must be resolved after consideration of all of the evidence in the record.[280]

There are three basic methods used to value real property and other assets:

- the market-data, or sales comparison, approach;
- the replacement-cost approach; and
- the capitalization-of-earnings approach.[281]

The market-data approach entails a comparison of the subject property to similar properties sold in the same time frame and geographic area. Differences that make a comparable property superior or inferior to the subject property are accounted for by adjusting the sale price of the comparable property upward or downward.[282] The validity of this method depends to a great degree upon the comparables selected and the reasonableness of the adjustments made thereto.[283]

The replacement-cost approach begins with an estimation of the value of the underlying land and then adds the cost of constructing equivalent improvements thereupon as if the improvements were new. From this figure is subtracted the amount by which the existing improvements have diminished in value from physical depreciation or obsolescence.[284]

The capitalization-of-earnings approach to valuation is premised on the correlation between the value of property and its expected income-producing power. Under this approach, value equals net annual operating income divided by a capitalization rate. The capitalization rate is influenced by many factors. Although basically related to the rate of interest, it also includes risk and liquidity factors and a recapture of capital component.[285] The selection of a capitalization rate represents the appraiser's subjective determination of the anticipated return on capital invested in the property. The lower the rate of capitalization, the higher the estimate of property value will be.[286]

c. Payment of Shareholder's Obligations by Corporation

It is well settled that if a corporation pays an obligation of its shareholder or makes a payment for the shareholder's benefit, the payment may be a constructive dividend to the extent of available earnings and profits.[287]

[275] *Palmer v. Commissioner*, 302 U.S. 63 (1937).

[276] *Jones v. Commissioner*, T.C. Memo 1993-162. *See also Missimer v. Commissioner*, T.C. Memo 1979-48.

[277] 99 T.C. 561 (1992).

[278] *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Marine v. Commissioner*, 92 T.C. 958, 982 (1989), *aff'd by unpub. opin.*, 921 F.2d 280 (9th Cir. 1991).

[279] *The Stanley Works & Subs. v. Commissioner*, 87 T.C. 389, 400 (1986). *See also Hilborn v. Commissioner*, 85 T.C. 677, 689 (1985).

[280] *See, e.g., Bardahl v. Commissioner*, T.C. Memo 1965-116.

[281] *See Marine v. Commissioner*, 92 T.C. 958 (1989), *aff'd by unpub. opin.*, 921 F.2d 280 (9th Cir. 1991).

[282] *See Estate of Spruill v. Commissioner*, 88 T.C. 1197 (1987); *Estate of Korman v. Commissioner*, T.C. Memo 1987-120.

[283] *See Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1, 19-20 (1979).

[284] *See Marine v. Commissioner*, 92 T.C. 958 (1989), *aff'd by unpub. opin.*, 921 F.2d 280 (9th Cir. 1991).

[285] *Narver v. Commissioner*, 75 T.C. 53 (1980).

[286] *Estate of Korman v. Commissioner*, T.C. Memo 1987-120. *See also Lanier, Inc. v. Commissioner*, T.C. Memo 1998-7 (capitalization-of-earnings approach is most suitable method when highest and best use of the property would have been to leave it for future development).

[287] *Apschnikat v. United States*, 421 F.2d 910 (6th Cir. 1970); *Ferro v. Commissioner*, 242 F.2d 838 (3d Cir. 1957), *aff'g* T.C. Memo 1956-94; *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947), *aff'g* 47-1 USTC ¶9178 (E.D. Va. 1947); *Smith v. Commissioner*, 70 T.C. 651 (1978); *Sachs v. Commissioner*, 32 T.C. 815 (1959), *aff'd*, 277 F.2d 879 (8th Cir. 1960). *See also Hood v. Commissioner*, 115 T.C. 172 (2000) (successor corporation's payment of legal

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This principle also applies when a payment by the corporation discharges a joint obligation of the corporation and its shareholders. In *Yelencsics v. Commissioner*,[288] the Tax Court held that payments by a corporation, in partial satisfaction of certain promissory notes, represented constructive dividends to its controlling shareholders. The shareholders had purchased the stock of the corporation from an individual for cash and promissory notes that were guaranteed by the corporation. The corporation paid the notes. The court found that the shareholders would have received a taxable dividend had the corporation made an actual distribution to them from its earnings and profits followed by the shareholders' payment of the distributed funds to their creditor. Thus, there was no difference between that transaction and the facts at issue. The court also found that the corporation's primary liability by virtue of its being a joint maker of the promissory notes had no significance because there was no valid business purpose for the corporation's incurring the primary liability.

The Tax Court reached the same conclusion in *Berger v. Commissioner*[289] with regard to a corporation's satisfaction, pursuant to its redemption of the stock of the shareholder's former wife, of its shareholder's obligation to purchase the stock of his ex-wife under a divorce decree. The corporation had no duties under the divorce decree. The Tax Court found that the shareholder's obligation to purchase the stock owned by his ex-wife was a personal and unconditional obligation and that its discharge necessarily resulted in a constructive dividend. Note, however, that if a shareholder does not have an unconditional obligation to buy the stock of another shareholder, but merely has a right similar to an option that the corporation exercises in a redemption of the corporate stock, the shareholder may not have received an economic benefit from the transaction and, therefore, has not received a constructive dividend.[290]

Other examples of corporate payments that result in constructive dividends include monthly payments by a corporation to a shareholder's divorced wife pending her remarriage[291] and payments made in discharge of a shareholder's wife's debts in connection with her purchase of a car and a pool built at the residence of the shareholder and his wife.[292]

d. Payments by Corporation to Shareholder Characterized as Rent

Excessive rental payments by a corporation in connection with lease arrangements with one or more of its shareholders provide an opportunity for funneling corporate earnings to the shareholder or shareholders under the guise of a deductible corporate expense, achieving a distribution of corporate earnings with only a single level of tax. Lease arrangements between a corporation and one or more of its shareholders have been the subject of scrutiny by the courts.

In *Jolly's Motor Livery Co. v. Commissioner*,[293] the Tax Court held that rental payments made by a corporation for the use of a vacant lot, purchased by the principal officer and controlling shareholder in the name of one of his sons, were constructive dividends in part. The court noted that the property had been purchased for little more than the annual amount of the rental payments made by the corporation, and that the corporation, in turn, had leased the property for one-fifth of the amount that it paid as rental. The amount of the dividend was the excess of the rental payments over the fair rental value of the property.

In *Sunnyside Beverages, Inc. v. United States*,[294] the shareholders of a corporation, who purportedly had divested themselves of their stock holdings by selling a portion of their stock to their daughter and son-in-law and exchanging the remaining shares for real estate owned by the corporation, were found to have retained an equity interest in the corporation by virtue of their leasing the real estate back to the corporation for a rental amount that included a set monthly payment plus a percentage of the corporation's net profits before taxes. The court held that the rental payments exceeded the fair rental value of the property and that the excess was a constructive dividend.

In *Maloney v. Commissioner*,[295] amounts that a corporation reimbursed to its controlling shareholders, in excess of rental amounts paid by the shareholders on behalf of the corporation, were determined to be constructive dividends to the shareholders.[296]

Comment: The common denominator of the cases involving constructive dividends disguised as rental payments is the rental of property to a corporation at an amount exceeding its fair rental value.[297] Evidence that rental payments do not exceed the fair rental value of the property should negate the appearance of a constructive dividend.[298]

e. Payments by Corporation to Shareholder Characterized as Guarantor's Fees

So-called guarantor's fees paid by a closely held corporation to its director-shareholders were held to be a distribution of property to the shareholders, taxable as a dividend to the extent of the corporation's earnings and profits, in *Tulia Feedlot, Inc. v. United States*.[299] The court relied on the following

fees to defend sole shareholder against criminal tax charges connected with sole proprietorship is constructive dividend to shareholder); FSA 200203061 (H received constructive distributions at time of payment when H's wholly owned corporation satisfied H's obligation, pursuant to divorce judgment, by paying W for her marital interest in corporation's stock).

[288] 74 T.C. 1513 (1980), *acq.*, 1981-2 C.B. 2.

[289] T.C. Memo 1974-172, *aff'd by unpub. opin.*, 538 F.2d 334 (9th Cir. 1976).

[290] *See Stout v. Commissioner*, 273 F.2d 345 (4th Cir. 1959).

[291] *Snyder v. Commissioner*, T.C. Memo 1983-692.

[292] *Hedrick v. Commissioner*, T.C. Memo 1980-54.

[293] T.C. Memo 1957-231.

[294] 71-2 USTC ¶9752 (N.D. Ind. 1971).

[295] T.C. Memo 1958-39.

[296] *See also W.H. Armston Co., Inc. v. Commissioner*, 188 F.2d 531 (5th Cir. 1951); *Greenspun v. Commissioner*, 7 T.C.M. 509 (1948).

[297] *Starer v. Commissioner*, T.C. Memo 2022-124 (shareholders' rent-free use of corporate property as their personal residence constituted a constructive dividend equal to the fair rental value of the property).

[298] *See also Palmarini Inc. v. Commissioner*, T.C. Memo 2022-119 (evidence of a rental arrangement, such as a documented rental agreement or recurring payments from which to infer such an arrangement, is also helpful to negate the appearance of a constructive dividend).

[299] 513 F.2d 800 (5th Cir. 1975). *See Seminole Thriftway, Inc. v. Commissioner*, 42 Fed. Cl. 584 (Fed. Cl. 1998) (guarantor fees paid to controlling shareholders for acting as guarantors were constructive dividends, because: (1) taxpayer had no valid business reason to pay shareholder's guarantor fees several years after they had guaranteed bonds personally without compensation or any expectation of compensation; (2) guarantor fees received by shareholders

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facts: (1) the corporation had substantial retained earnings but had declared no dividends until after the year in issue; (2) the amount of the fees, amounting to 3% of the amount guaranteed by each shareholder, was not determined by taking into account the risks involved in the guarantees (and at least two of the guarantors made guarantees in excess of their net worth); and (3) the fees seemed to have been paid in response to some of the shareholders' expressions of dissatisfaction with the corporation's dividend policy. Although evidence was submitted that one of the corporation's banking credit sources would not have lent money to the corporation without the personal guarantees of the corporation's shareholders and that such guarantees were commonly required of closely held corporations in the corporation's line of business, the court noted that no evidence had been presented to show that it was customary for the shareholders of a corporation in the corporation's line of business to charge a fee for their guarantees, or that the fees, given the risks involved, were reasonable under the circumstances presented.

In a subsequent action, however, evidence was introduced that: (1) the third-party lender required, as a condition precedent to making loans to the corporation, that the loan repayment be personally guaranteed to the extent of 100% of the anticipated indebtedness by one or more individual guarantors; (2) each shareholder had decided on the amount that he or she was willing to guarantee, which amounts were not in proportion to the shareholders' stockholdings; (3) the corporation had looked into alternative means of financing and concluded that having the shareholders guarantee the loans, for a fee, was the optimal means of financing the operations of the corporation; (4) it was customary for corporations in a similar line of business to pay guarantor fees of between 3% and 5% to the shareholders; and (5) that the corporation's guarantors were unwilling to provide the required guarantees unless they received fees of 3%. The fees were allowed to the corporation as ordinary and necessary business expenses for income tax purposes, and, therefore, did not represent constructive dividends.[300]

f. Payment by Corporation of Shareholder's Personal Expenses

The payment by a corporation of the personal expenses of its shareholder generally results in a constructive dividend to the shareholder, to the extent of the corporation's earnings and profits, if the corporation has no expectation of repayment. Generally, the amount of the constructive dividend is equal to the fair market value of the benefits received.[301]

Numerous cases have held that a shareholder receives a constructive dividend when the corporation pays the shareholder's personal expenses. These cases have involved:

- travel and entertainment expenses when the shareholder did not substantiate the expenses' legitimate connection to the business of the corporation;[302]
- reimbursement of a shareholder's round-trip airline tickets from Florida, where he had his winter vacation home, to Wisconsin, where the corporation was located;[303]
- a shareholders' use of corporate aircraft to travel from the shareholder's home to the corporation's headquarters;[304]
- gardening expenses and a portion of certain improvement and utility expenses incurred with regard to residential property transferred by the chairman of the board and shareholder to the corporation, and in which the shareholder continued to live by virtue of his reserved life estate in the property;[305]
- trips overseas that were devoid of any business purpose;[306]
- contributions to local churches;[307]
- private school tuition for the shareholder's daughter and country club dues;[308]
- payment of sole shareholder's mortgage;[309]
- apartment-rental payments, automobile expenses, clothing, laundry, and food of shareholder who was also a salesman, purchaser, and the chief executive officer of the corporation;[310]
- personal use of a company-owned automobile;[311] and
- entertainment expenses and club dues when the shareholder failed to establish that the club was used primarily to further the corporation's business or that the expenditures were directly related to the active conduct of the trade or business of the corporation.[312]

In addition, in *Hagaman v. Commissioner*,[313] construction payments made by a corporation for the homes of two employees who were related to the principal shareholder were treated as constructive dividends to the shareholder and not, as the shareholder had argued, income to the related employees.

In contrast to *Hagaman*, in *Reeves v. Commissioner*,[314] payments made by a corporation to build a houseboat, dock and floating garage used in part by its sole shareholder were not

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were directly proportional to their ownership interests; and (3) taxpayer failed to pay dividends even though it was profitable).

[300] *Tulia Feedlot, Inc. v. United States*, 83-2 USTC ¶9516 (Ct. Cl. 1983). *See also A.A. & E.B. Jones Co. v. Commissioner*, T.C. Memo 1960-284. *Cf. Universal Milking Mach. Co. v. Commissioner*, 4 B.T.A. 506 (1926).

[301] *Challenge Mfg. Co. v. Commissioner*, 37 T.C. 650 (1962), *acq.*, 1962-2 C.B. 4; *Halpern v. Commissioner*, T.C. Memo 1982-31.

[302] *Halpern v. Commissioner*, T.C. Memo 1982-31.

[303] *Munson v. Commissioner*, T.C. Memo 1980-121.

[304] *Ireland v. United States*, 621 F.2d 731 (5th Cir. 1980).

[305] *Crosby v. United States*, 496 F.2d 1384 (5th Cir. 1974).

[306] *Oleander Co. v. United States*, 82-1 USTC ¶9395 (E.D.N.C. 1981).

[307] *Oleander Co. v. United States*, 82-1 USTC ¶9395 (E.D.N.C. 1981).

[308] *Oleander Co. v. United States*, 82-1 USTC ¶9395 (E.D.N.C. 1981).

[309] *Brown v. Commissioner*, T.C. Summ. Op. 2017-21.

[310] *Davis v. Commissioner*, T.C. Memo 1975-370. *See also Pittman v. Commissioner*, 100 F.3d 1308 (7th Cir. 1996) (corporation's payments of personal expenses of president, who was 50% shareholder, including mortgage payments, real estate taxes, and credit card payments, were constructive dividends to shareholder); *Palmarini Inc. v. Commissioner*, T.C. Memo 2022-119 (corporation's payments for maintenance and upkeep of shareholder's rental properties, medical bills of shareholder and family, a family trip, and a personal vehicle were constructive dividends to shareholder).

[311] *Commissioner v. Riss*, 374 F.2d 161 (8th Cir. 1967). *See also McGee v. Commissioner*, T.C. Memo 1991-599; *L.R. Schmaus Co., Inc. v. Commissioner*, T.C. Memo 1967-197, *rev'd on another issue*, 406 F.2d 1044 (7th Cir. 1969).

[312] *Zimco Elec. Supply Co. v. Commissioner*, T.C. Memo 1971-215.

[313] 958 F.2d 684 (6th Cir. 1992).

[314] T.C. Memo 2007-273.

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considered constructive dividends. The corporation and shareholder shared the costs of such construction (the shareholder bearing approximately 30% of the costs), and the structures were used for both corporate events and by the shareholder for personal use (approximately ten times a year). Title to the structures was in the corporation's name, and the corporation was compensated for the sale of the structures in connection with shareholder's bankruptcy. The court found the shareholder's portion of the payment for the construction allowed him a reasonable amount of personal use without the corporation conferring a benefit and thus no constructive dividend was present.

g. Other Transactions

The determination of whether a payment by a corporation to its shareholders is an ordinary and necessary business expense or a dividend distribution of corporate profits is based on the facts and circumstances.[315] A significant factor is whether the payment has independent and substantial importance to the paying corporation.[316]

In *Cleveland Shopping News Co. v. Routzahn*,[317] stockholders of a corporation contracted with the corporation to advertise at cost plus 7%, and the 7% was deposited in a special account used to redeem the stock of those who had ceased to advertise and to offset extraordinary expenses. Amounts remaining in the account were distributed to stockholders in accordance with the amounts paid into the account fund, and the company claimed a deduction for the amount distributed. The court denied the company's claim that the amounts distributed, which had not been reported in the taxpayer's income, were rebates and held that they were dividends or distribution of profits to shareholders even though the distribution was not in proportion to stockholdings.

In *Peoples Gin Co., Inc. v. Commissioner*,[318] the taxpayer ginned cotton for its shareholders and third parties. In mid-1933, it adopted a resolution providing for the distribution of dividends "before any profits should be 'prorated on a baleage basis.'" Subsequently, after the end of the ginning season, the taxpayer's bylaws were amended to provide that profits from ginning for shareholders were to be divided among the shareholders in proportion to the bales ginned for them and profits from ginning for non-shareholders were to be divided in proportion to shareholdings. Profits from ginning for shareholders for the 1933 ginning season were distributed early in 1934. The court found that the distribution was not made pursuant to a resolution adopted before the period in which the distributed amount had been earned and held the distribution to be a dividend and not a rebate, even though it was made on a basis other than shareholdings.[319]

A shareholder's uncompensated use of a corporate-owned asset is a constructive dividend in the amount of the fair rental value of the use of the asset. In FSA 199945017, corporation C and a shareholder (SH) entered into a lease agreement in which SH leased one of C's assets. The terms provided that the lease could be cancelled upon default of payment by SH. In the event the lease terminated, SH was required to return the asset to C. After C relocated its operations to state Y, SH retained the asset in his home but stopped making lease payments. SH argued that his residence was C's corporate office in state X, so that, when the lease terminated, the asset was "returned" to C's corporate office in state X.[320]

Citing *Sparks Nugget, Inc. v. Commissioner*,[321] the Chief Counsel's Office stated that a constructive dividend can be of an indirect financial nature, such as a gift on the shareholder's behalf, the fulfilling of a moral obligation of the shareholder, or assisting the shareholder in hobby pursuits. Therefore, because SH personally benefited from use of the asset in his home, SH had either a constructive dividend equaling the fair market value of the asset's use following the lease termination, or, if the asset's use could be deemed to be compensation, ordinary income equal to the fair market rental value during the same period. In the case of deemed compensation, C could deduct the fair market rental value.

In *Bemidji Distrib. Co. v. Commissioner*,[322] a corporation sold its assets for cash with the parties allocating no consideration to corporate intangibles such as goodwill or going concern value. Amounts were allocated to the sole shareholder's consulting agreement and covenant not to compete. The court reallocated a portion of the consideration allocated to the noncompete to other corporate intangibles and held that such reallocated amount was constructively distributed to the sole shareholder as ordinary dividend income in the transaction. The court further found the portion of the corporation's transaction expenses attributable to the negotiation of the shareholder's consulting agreement and covenant not to compete primarily benefitted him (and not the corporation) and thus were to be considered a constructive dividend to the shareholder.

For a discussion of constructive-dividend treatment to other shareholders of a shareholder's waiver of rights to receive a dividend, see III.D.3., above.

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[315] *See Rubber Assocs., Inc. v. Commissioner*, 335 F.2d 75 (6th Cir. 1964); *Lengsfield v. Commissioner*, 241 F.2d 508 (5th Cir. 1957).

[316] *See T.J. Enters., Inc. v. Commissioner*, 101 T.C. 581 (1993); *Maxwell v. Commissioner*, 95 T.C. 107 (1990) (requiring reasonable basis, independent of tax considerations, for taxpayer's characterization of payment); *Fairmont Homes, Inc. v. Commissioner*, T.C. Memo 1983-209 (allowing as deduction those payments made to induce shareholder to take course of action favorable to payor-business).

[317] 89 F.2d 902 (6th Cir. 1937).

[318] 118 F.2d 72 (5th Cir. 1941).

[319] *See also* Rev. Rul. 83-141 (relying on *Cleveland Shopping* and *Peoples Gin*); TAM 9830003 (rebates based on use of system by members and their customers to access bank funds ruled deductible under §162).

[320] *See also* PLR 200215036 (shareholder's discounted use of corporate-owned asset is constructive dividend; corporation gave its shareholders discounts on food and beverage purchases, golf membership dues, and cart rental and range fees with respect to corporation's country club; IRS ruled that excess of fair market value over amount paid by shareholders for discounted items was distribution of property that constituted constructive dividend).

[321] T.C. Memo 1970-74 (1970), *aff'd*, 458 F.2d 631 (9th Cir. 1972).

[322] T.C. Memo 2001-260, *aff'd*, 59 Fed. Appx. 168 (8th Cir. 2003). *See also Howard v. United States*, 448 Fed. Appx. 752 (2011) (where goodwill was transferred from doctor to practice upon doctor entering into covenant not to compete, goodwill proceeds from sale of doctor's incorporated dental practice were properly characterized as dividend from practice to doctor). *Contrast Bross Trucking, Inc. v. Commissioner*, T.C. Memo 2014-107 (corporation found not to have distributed intangibles to its sole shareholder (and thus shareholder not to have subsequently gifted such to his sons for use in a newly formed company) because such intangibles had either devalued or were personal to sole shareholder).

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h. Payment by Corporation to Shareholder Characterized as Compensation

Reg. §1.162-7(b)(1) provides that a compensation payment is "likely" to be a nondeductible dividend if the corporation is closely held and the excessive compensation payment bears a close relationship to the shareholder's stock holdings. The corporation's failure to declare any other dividend is another factor indicating that a compensation payment is a disguised dividend, although this characterization is not automatic.[323] In determining the effect of a lack of dividends, the courts apply an "independent investor" standard, which takes into account the absence of dividends in determining the reasonableness of compensation only insofar as excessive compensation would unacceptably decrease the corporation's rate of return on equity for a substantial independent shareholder who is not actively engaged in the business.[324] Assuming that a payment is properly treated as compensation, if made in-kind with property having a basis different than the fair market value of the services rendered, the corporation would recognize gain or loss under the general rules of §1001 even though the employee happens to be a shareholder, i.e., §311 should not apply because the distribution is not paid with respect to the corporation's stock.

For further discussion of this issue, see 390 T.M., *Reasonable Compensation.*

i. Cancellation of Shareholder Loans

As discussed above, when a corporation makes an advance to a shareholder that has the proper indicia, the advance will be respected as a bona fide loan if the parties involved respect the formalities of the note. A borrower will generally recognize income from the cancellation of indebtedness under §61(a)(11) upon cancellation of a note. Under Reg. §1.301-1(k), the cancellation of indebtedness of a shareholder by a corporation is treated as a distribution to the shareholder. The amount included in the shareholder's gross income could be the same whether treated as a distribution or cancellation of indebtedness income. Under the current rate structure, there could however be a preferential rate to the shareholder as cancellation of indebtedness is ordinarily taxed as ordinary income rate which could be as high at 37% whereas taxable dividends discussed above have a preferential lower rate. The justification for this treatment lies in the principal purpose behind the origin of the shareholder loan. Corporations do not normally distribute cash to a single shareholder. Rather distributions are pro-rata. A loan made to a shareholder, who is also an employee of the corporation, may alternatively characterized as a compensation to the shareholder and taxed at ordinary rates.

j. Surrender of Shares to the Capital of a Corporation

Shareholders who voluntarily surrender their shares to a corporation without any form of consideration to the capital of the corporation must determine the federal income tax consequences of their share surrender. To determine the impact to the noncontributing shareholders, one might look to §305(c), which states:

> For purposes of this section and §301, the Secretary shall prescribe regulations under which a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which §301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder shall be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction.

Although this provision applies to stock distributions, the increase in proportionate ownership in the corporation, by virtue of the contributing shareholder's share surrender, could be viewed as constructive stock distributions to the noncontributing shareholders.[325]

In PLR 202406002, an executive and trust shareholder contributed a proportionate amount of common shares to the company for no consideration for valid business reasons. The IRS concluded that the share contribution will not be treated as a distribution of property to the noncontributing shareholders. The taxpayer in the ruling represented that (i) the stock surrendered will be cancelled, (ii) the stock or similar shares of stock will not be returned to the contributing shareholders, (iii) the contribution is an isolated transaction, and (iv) the contribution is not part of a plan to periodically increase the proportionate share of any shareholder in the assets or earnings and profits of the company. Key to the private letter ruling was the representation that the surrender and contribution of capital of the shares was made in isolation and not connected to the surrender of stock because a redemption or recapitalization is an isolated transaction and is not characterized as a constructive distribution under Reg. §1.305-3(b)(3).[326]

2. Transactions Between Affiliated Corporations Resulting in Constructive Dividends to Common Shareholders

a. In General

The IRS takes the position that intercompany transfers of property between corporations in a brother-sister relationship, without adequate consideration, are constructive dividends to the common shareholders, to the extent of the earnings and profits of the transferring corporation, regardless of the motives

[323] *See Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983); Rev. Rul. 79-8.

[324] *See Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983). *See also Donald Palmer Co. v. Commissioner*, T.C. Memo 1995-65, *aff'd per curiam*, 84 F.3d 431 (5th Cir. 1996) (deduction disallowed for excessive compensation when payments resulted in negative retained earnings and return on investment would not be acceptable to hypothetical investor). *See also Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner*, 680 F.3d 867 (7th Cir. 2012) (accounting firm operating as C corporation paid "consulting fees" to entities owned by founding shareholders (which in turn passed the monies to the founding shareholders); court upheld treatment of payments as dividends because if treated as deductible fees, firm's income would be reduced to zero (or less) for several years and thus eliminate return on equity despite the firm's clear financial well-being, thus flunking the independent investor test).

[325] *See* Willens, "Stock Contribution Did Not Beget a Constructive Distribution or Gift," *Tax Notes* (April 18, 2024).

[326] *See* Willens, "Stock Contribution Did Not Beget a Constructive Distribution or Gift," *Tax Notes* (April 18, 2024).

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for the transfers, and even if the common stockholders have not received funds from either corporation. The transfers may be a result of excessive charges for services rendered between brother-sister corporations or of bargain sales between brother-sister controlled corporations.[327] Intercorporate transfers resulting from a §482 allocation usually result in a constructive dividend to the common, controlling shareholders.[328]

The term "brother-sister corporations" normally is applied to two (or more) corporations owned directly by the same controlling shareholders. The term also encompasses corporations held through intervening corporate entities, so long as neither corporation owns the other directly or indirectly.[329]

In Rev. Rul. 78-83, domestic corporation P formed wholly owned foreign corporation Y to act on behalf of P's foreign subsidiary, X. Y received part of the sales price charged by X with regard to X's sale of fiber. Some of the money accumulated by Y was used to pay refunds to foreign customers and travel expenses of X's employees, as well as to pay certain promotion expenses in connection with the fiber sales. The funds diverted from X to Y were in excess of the amounts necessary to provide Y with reasonable compensation for its services to X and to reimburse Y for the expenses incurred on X's behalf. The IRS ruled that the income of X diverted to Y, in excess of the disbursement on behalf of X and reasonable compensation for services of Y, was a distribution taxable as a dividend to P, to the extent of X's earnings and profits, and as an equivalent capital contribution by P to Y. The IRS stated, "A constructive dividend is paid when a corporation diverts property, directly or indirectly, to the use of a shareholder without expectation of repayment, even though no formal dividend has been declared."

In cases involving corporations controlled by the same persons, the courts generally have found that a constructive dividend was distributed to the common shareholders if one of the corporations was used as a device for siphoning off the earnings and profits.[330] However, a constructive dividend is a diversion of the property, not of the income. Income is a characterization that tax law attributes to certain receipts of property, whereas a constructive distribution is a distribution of property itself. Thus, if property is transferred from one affiliate to a sister corporation without adequate consideration therefor, there is a constructive distribution to the common parent whether or not the motive for the transfer was an attempt improperly to allocate income or deductions between the corporations.[331]

[327] *See* Rev. Rul. 78-83, Rev. Rul. 69-630.

[328] *See Eng'g Sales, Inc. v. United States*, 510 F.2d 565 (5th Cir. 1975), *rev'g* 74-1 USTC ¶9211 (N.D. Ala. 1974); *Sparks Nugget, Inc. v. Commissioner*, 458 F.2d 631 (9th Cir. 1972), *aff'g* T.C. Memo 1970-74; *Bell v. Commissioner*, T.C. Memo 1982-660.

[329] *Sammons v. Commissioner*, 472 F.2d 449, 453–54 (5th Cir. 1972), *aff'g in part, rev'g in part, and rem'g* T.C. Memo 1971-145.

[330] *See Biltmore Homes, Inc. v. Commissioner*, 288 F.2d 336 (4th Cir. 1961); *Commissioner v. Greenspun*, 156 F.2d 917 (5th Cir. 1946); *Helvering v. Gordon*, 87 F.2d 663 (8th Cir. 1937).

[331] *Cf. Columbian Rope Co. v. Commissioner*, 42 T.C. 800 (1964) (no constructive dividend resulted to common shareholder), *acq.*, 1965-1 C.B. 4.

b. The Objective and Subjective Tests: Sammons v. Commissioner

Notwithstanding the foregoing, some courts have refused to uphold constructive-dividend treatment to the controlling shareholders of affiliated corporations in cases in which the intercompany transfers are justified by an appropriate business purpose or in which the controlling shareholders have not received a direct economic benefit from the transfer.

In *Sammons v. Commissioner*,[332] the Fifth Circuit refused to uphold the Tax Court's determination that a constructive dividend resulted. In *Sammons*, C, an individual, owned 99% of R, which in turn owned a substantial interest in S. S agreed to indemnify C for any losses he might incur as a result of his guaranteeing a bank loan to X, S's subsidiary. C later substituted his personal note to the bank for his guaranty of X's debt. X was unable to pay the loan. R and other corporations controlled by C then purchased X's preferred stock, and X used the proceeds of the sale to pay C, who, in turn, paid the bank.

Because the payment received by C from X was in satisfaction of X's obligation to C, the court found that any resulting dividend must have been the result of transfers of funds between the various corporate entities involved rather than a direct transfer to C, the controlling shareholder. Furthermore, the court noted, not all transfers from one corporation to another are dividends to a common shareholder. In determining whether a dividend resulted from the subject transactions, the court used a bifurcated inquiry consisting of an objective and a subjective test. Under the bifurcated approach, both tests must be satisfied for a transaction to be characterized as a dividend.

The objective test determines whether the transfer caused funds or other property to leave the control of the transferor corporation and allowed the stockholder to exercise control over the funds, either directly or indirectly, other than through the transferor corporation. If the objective test is satisfied by a transfer of funds from one corporation to the other, rather than by a direct transfer to the controlling shareholder, then the subjective test is applied. The subjective test determines the purpose of the transfer, to differentiate between normal business transactions of related corporations and transactions designed primarily to benefit the shareholder. If the business justifications are not sufficient to refute a conclusion that the distribution was primarily for the benefit of the shareholder, the subjective test is met.

Although the Fifth Circuit agreed with the Tax Court that the transaction satisfied the subjective test,[333] it held that the objective test was not satisfied because funds were transferred down the corporate chain of ownership and, therefore, the essential requirement of a constructive dividend — that the shareholder receive something from the corporation — was not met. Thus, a transfer of funds by a corporation to another directly or indirectly owned corporation results in a constructive dividend to the individual common or controlling shareholder only

[332] 472 F.2d 449 (5th Cir. 1972), *aff'g in part, rev'g in part, and rem'g* T.C. Memo 1971-145.

[333] Even though the court stated that the subjective test is only applied if the objective test is satisfied, it nevertheless applied the tests in reverse order because the case "[required] that both tests be applied," and then concluded that the objective test was not satisfied. 472 F.2d at 451–52.

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if: (1) the funds are diverted from the parent-subsidiary corporate structure and come under the control of the stockholder; and (2) no adequate consideration for the diversion passes from the stockholder to the corporation. The court in *Sammons* held that, because C received the payments from X in his capacity as a creditor, and not as a stockholder, and because full consideration passed to the corporation when the debt was created, the repayment did not effect a distribution to C.[334]

The *Sammons* principles are reflected in several Tax Court decisions, including *Rushing v. Commissioner*,[335] in which the sole shareholder of two corporations was found not to have received a constructive dividend when one corporation advanced funds to the other, because there was a proper business purpose for the advances and whatever personal benefit the common shareholder received was derivative and not direct. Similarly, in *Rapid Electric Co., Inc. v. Commissioner*,[336] a Puerto Rican company's extension of credit on its books to its financially troubled New York sister corporation was held not to be a constructive dividend to their sole shareholder because the advances were neither made primarily for the benefit of the shareholder nor resulted in any direct benefit to the shareholder. The court stated, "Any benefit which may have accrued to [the shareholder] as a result of the extension of credit was merely derivative in nature and insufficient to justify the inference of a taxable dividend."[337] However, the court did not consider whether the advances provided the New York corporation with working capital that it might not have been able to obtain otherwise or that the shareholder might otherwise have had to provide. The court also did not consider whether the advances kept the New York corporation operational, thereby preserving the value of the shareholder's investment.[338]

c. Types of Intercompany Transactions Resulting in Constructive Dividends

As in the case of constructive dividends arising from transactions directly between a shareholder and a corporation or between a corporation and a third party, constructive dividends resulting from transactions among corporations standing in a brother-sister relationship arise in a variety of scenarios. For example, constructive dividends may result from transactions cast as sales of property between affiliated corporations, intercompany loans, loans to shareholders, allocations of consolidated-tax liability, lease arrangements between affiliated corporations, and payments for services, among others.

(1) Transactions Characterized as Sales of Property Between Affiliated Corporations

In general, the IRS considers a transaction to result in a constructive dividend to the common shareholders of corporations standing in a brother-sister relationship when property is transferred from one corporation to the other for less than fair market value.

In Rev. Rul. 69-630, the IRS ruled that one corporation's sale of property for less than arm's-length price to another corporation controlled by the same shareholder resulted in a distribution by the selling corporation to the controlling shareholder in the amount of the bargain element and an equivalent contribution to the capital of the purchasing corporation. The basis of the property in the hands of the purchasing corporation was also increased by the bargain element to reflect the arm's-length price.

In Rev. Rul. 73-605, the principles of Rev. Rul. 69-630 were extended to payments made pursuant to an allocation agreement regarding a group's consolidated tax liability. See IV.F.2.c.(4). In Rev. Rul. 78-83, the principles of Rev. Rul. 69-630 were extended to payments for services rendered between foreign subsidiaries.

> *Example:* A owns all the stock of each of corporations X and Y. X sells a $100 asset to Y for $50 to keep the other $50 in Y. X is deemed to make a constructive distribution to A in the amount of $50; A is deemed to contribute $50 to Y's capital.

(2) Transactions Characterized as Intercompany Loans

In *Joseph Lupowitz Sons, Inc. v. Commissioner*,[339] intercompany transfers were held not to be constructive dividends to the common shareholders of the two corporations. There was no express agreement or understanding between the management of the two corporations as to repayment or with respect to the payment of interest on the transferred funds. However, both corporations treated the transfers as creating an obligation at the corporate level, i.e., the amounts involved were to be repaid to the corporate entity from which the funds were derived. The court determined this to be the cardinal fact distinguishing the transfer in this case from transfers of property in which the shareholders of the recipient corporation received a tangible benefit.[340] The court stated that the existence of the obligation and the retention of the obligation at the corporate level also served to distinguish *Lupowitz* from cases in which the funds transferred were siphoned off to or for the benefit of a shareholder. With regard to the ability of the transferee corporation to obtain the use of the funds of the transferor corporation on an interest-free basis, the court considered that element an insufficient foundation for holding that the net transfers of funds were a constructive dividend. The lack of a specific business purpose in making the transfers was held not to be determinative of the existence of a constructive dividend.

In contrast, transfers of funds from one corporation to another, both wholly owned by the same shareholders, were held to be constructive dividends to the common shareholders in

[334] For cases in which a constructive dividend to the stockholder was upheld, *see Tollefsen v. Commissioner*, 52 T.C. 671 (1969), *aff'd*, 431 F.2d 511 (2d Cir. 1970); *Kaplan v. Commissioner*, 43 T.C. 580 (1965); *Meyer v. Commissioner*, 45 B.T.A. 228 (1941), *acq.*, 1942-1 C.B. 12.

[335] 52 T.C. 888 (1969), *aff'd on another issue*, 441 F.2d 593 (5th Cir. 1971).

[336] 61 T.C. 232 (1973), *acq.*, 1974-2 C.B. 4.

[337] 61 T.C. at 240.

[338] For other cases rejecting constructive dividend treatment to the common shareholders of related corporations, see *Offutt v. Commissioner*, 336 F.2d 483 (4th Cir. 1964), *aff'g* T.C. Memo 1963-126; *Dean v. Commissioner*, 57 T.C. 32 (1971); *PPG Indus., Inc. v. Commissioner*, T.C. Memo 1970-354.

[339] 497 F.2d 862 (3d Cir. 1974), *rev'g in part, aff'g in part, and rem'g* T.C. Memo 1972-238.

[340] The court examined *Sparks Nugget, Inc. v. Commissioner*, 458 F.2d 631 (9th Cir. 1972), *Sammons v. United States*, 433 F.2d 728 (5th Cir. 1970), *Worcester v. Commissioner*, 370 F.2d 713 (1st Cir. 1966), and *Equitable Publ'g Co. v. Commissioner*, 356 F.2d 514 (3d Cir. 1966).

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Wilkof v. Commissioner.[341] The Tax Court determined that the transfers at issue in *Wilkof* were not bona fide loans. It found that the shareholders had directly and primarily benefited as a result of the transfers in that: (1) they were able to use the transferor corporation as a source of risk capital for the transferee corporation without using their personal resources; (2) they could carry on a business with extremely thin capitalization without having their personal funds subordinated to the substantial indebtedness of the transferee corporation; (3) the transfers greatly increased the value of their equity interests in the transferee corporation; and (4) they were relieved of potential liability on their personal guarantees of loans made by third parties to the transferee corporation that were partially paid off with the funds advanced by the transferor corporation. The court also stated that no satisfactory business purpose had been advanced for the transfers other than the supplying of a large amount of risk capital to a corporation wholly unrelated in function and operation to the transferor corporation.

The court stated:

> A corporate purpose, be it specific or general, must demonstrate the necessary relationship between the transferor corporation and transferee corporation such that a transfer of funds would be in the best interests of the transferring corporation at the corporate level. To the extent that a corporation "loans" funds to another related corporation, creating an obligation on the corporate level, we have always construed such a transfer as having a primary corporate purpose, whether or not the corporations were in similar, tangential or supporting fields … . If we do not find a loan to exist, and a corporation transfers funds or property to a related corporation, such transfers are highly suspect. In that case the transfers may in fact be a circuitous route at achieving capital financing of the transferee corporation without dividend treatment by the transferor to the common shareholder. If justifiable business reasons exist, however, that could account for the transfer of funds between related corporations, such reasons would be sufficient to override any benefit that might incidentally or derivatively accrue to the transferor's shareholders.[342]

In *McLemore v. Commissioner*,[343] the transfer of funds from one company to another to help the transferee corporation retain a profitable status and to protect the transferor corporation's interest as landlord in property rented by the transferee corporation was determined to be insufficient as a primary business purpose. The court held that the funds, which were paid to the common shareholders in satisfaction of the transferee corporation's debt to them, were a constructive dividend.

Similarly, in *J.S. Stevenhagen Co. v. Commissioner*,[344] advances from one corporation to another were found to have been made initially for the purpose of getting the transferee corporation underway and later for furthering its business and making it a viable and profitable corporation. The court concluded that the transfers served to enhance the value of the shareholder's interest in the corporation and were a primary benefit to him. It acknowledged that the transferor corporation might gain if the transferee corporation became profitable, but viewed such a possibility as merely "derivative to" the taxpayer's enhanced investment in the transferee corporation.

In *Kelly v. Commissioner*,[345] the transfers of funds from a company controlled by an individual shareholder to the shareholder and other companies controlled by the shareholder were held to be constructive dividends instead of loans. The court noted that objective factors have been established by case law for the purpose of determining whether a bona fide debtor-creditor relationship exists. In this case, the court focused on the factor of whether the "borrower" had a reasonable prospect of repaying the "loans" and concluded that the shareholder was well aware that the downturn in the economy had made repayment all but impossible.

Practice Point: The liquidity of a closely held corporation at the time the distribution is made is a significant factor in characterizing a loan, as a thinly capitalized corporation generally has no business purpose to loan money that it would need for its ongoing operations.

As these cases demonstrate, the determination of whether transfers characterized as intercompany loans are dividends to the common shareholder is a factual one, dependent upon the particular circumstances of each case and the court's view of what constitutes the receipt by the common controlling shareholder of a benefit significant enough to merit dividend treatment. Similar facts have produced different results.

(3) Transactions Characterized as Loans to Shareholder

In *Kaplan v. Commissioner*,[346] the Tax Court held that amounts received, in the form of non-interest-bearing open-account advances, from a wholly owned subsidiary of a corporation of which the taxpayer was the sole shareholder, were distributions to him by the parent corporation with respect to its stock and, therefore, were taxable to him to the extent of the parent's earnings and profits. Most of the liquid funds that the subsidiary had advanced to the taxpayer had been supplied by its parent and by its sister-subsidiary, which had liquidated and distributed its net assets and accounts to the parent.[347] The court noted that the advances to the shareholder did not serve any corporate business purpose of either the subsidiary or the parent corporation but were intended to be used by the taxpayer for his own personal use in purchasing securities in his own

[341] T.C. Memo 1978-496, *aff'd per curiam*, 636 F.2d 1139 (6th Cir. 1981). *See also Estate of Fry v. Commissioner*, T.C. Memo 2024-8 (fund transfers from one S corporation to another at the direction of both corporations' sole shareholder were constructive distributions to the shareholder rather than debt between the corporations; shareholder primarily benefited from the transfers because the recipient corporation needed the funds to continue operations); *Aredco Inc. v. Commissioner*, T.C. Memo 1995-283 (transfer of funds between brother-sister corporations deemed to be equity contribution, not debt, and held to be constructive dividend to sole shareholder, who benefited from the contribution). *See* Yuhas & Fellows, *Related Corporations and Triangular Dividends: Can the Circle Be Squared?*, 73 TAXES 539 (Oct. 1995), for a discussion of *Aredco* and the issue of triangular dividends in general.

[342] T.C. Memo 1978-496.

[343] T.C. Memo 1973-59, *aff'd*, 494 F.2d 1350 (6th Cir. 1974).

[344] T.C. Memo 1975-198, *aff'd*, 551 F.2d 106 (6th Cir. 1977).

[345] T.C. Memo 2021-76.

[346] 43 T.C. 580 (1965).

[347] The subsidiary had large deficits in its earnings and profits and was in no financial condition to make unsecured and interest-free loans of indefinite duration. *See* 43 T.C. at 591–592.

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name that were expected to be held as permanent investments. Indeed, none of the advances were repaid. The court stated:

> It is well settled that withdrawals made from a corporation by its controlling stockholder, without security and without interest, for his own personal use and benefit, and without any intention to make repayment, constitute distributions by the corporation with respect to its stock, and that such distributions are taxable to the shareholder as dividends to the extent of the corporation's earnings and profits … . The fact that the corporation may have charged such withdrawals to a loan account, is not determinative of the character of the withdrawals, for book records, though they should be given consideration, are not conclusive … .
>
> Also, where an individual is in control of two corporations, and he causes assets representing earnings and profits of one of his corporations to be shifted over to the other of his corporations, he will be treated as having received a dividend from the corporation from which the assets were shifted.[348]

(4) Allocations of Consolidated Tax Liability

In general, §316 defines "dividend" as any distribution of property made by a corporation to its shareholders out of its earnings and profits. This definition has been found to encompass an amount paid by a corporation, under an agreement or contract that exceeds its allocable share of the consolidated tax liability.[349] The excess payment results in a constructive dividend to the common shareholder followed by a capital contribution from the common shareholder to the corporation receiving the excess funds.[350]

In Rev. Rul. 73-605, the members of an affiliated group entered into an agreement providing for the filing of a consolidated federal income tax return and the allocation of the consolidated tax liability in accordance with §1552(a), the computation of a hypothetical tax for each member of the affiliated group on a separate return basis, and a transfer of funds from members whose hypothetical tax was reduced to members whose losses or credits generated the tax deductions. All funds were paid to the common parent, which disbursed the funds in accordance with the agreement. The IRS applied the principles discussed above and ruled that the excess payments made by some of the members of the group represented dividends paid by those members to the parent, followed by a contribution by the parent, in the amount of the dividend, to the capital of the members whose losses resulted in a tax savings to the group.[351]

(5) Transfers Characterized as Rent Payments

Like lease arrangements involving the rental of property by a shareholder to a corporation for an amount exceeding the fair rental value of the property, lease arrangements between affiliated corporations can result in constructive dividends to their common controlling shareholders.

Excessive rental payments made under an agreement between related corporations not dealing at arm's length, which served no corporate business purpose but benefited the controlling shareholder, were held to be constructive dividends from the lessor corporation to the controlling shareholders in *Sparks Nugget, Inc. v. Commissioner*.[352] The amount of the dividend equaled the amount of the excess payments. The Tax Court also held that the controlling shareholders made a corresponding capital contribution to the lessee corporation.

(6) Transfers Characterized as Payments for Services

Transfers between commonly controlled corporations that purportedly represent payment for services rendered have been held to be constructive dividends when the payments are excessive, devoid of a valid corporate purpose, or made for the personal purposes or benefit of the controlling shareholders. For example, in *Knipe v. Commissioner*,[353] the Tax Court held that a publishing company's payments to its sister corporation, under advertising participation agreements entered into by the corporation's officers and stockholders, the payments were constructive dividends to the common stockholders of the two corporations. The court noted that the payments by the corporation to its sister corporation were made for no discernible consideration and had no business purpose. It held that the stockholders were taxable on the payments because they caused the payments to be made for their own purposes, even if they themselves received no economic gain.[354]

In *Bell v. Commissioner*,[355] the three shareholders of a professional association that employed them as physicians organized an S corporation to own and operate an x-ray laboratory. Both corporations shared the same physical facilities. The professional association paid 85% of the gross charges billed to its clients to the S corporation. The S corporation did not pay rent to the professional association for the use of its office space or for any expenses attributable to that space. The Tax Court sustained an allocation, pursuant to §482, of the amounts in excess of the arm's-length charges for the services rendered by the S corporation to the professional association. The court also sustained the IRS's determination of a constructive dividend to the shareholders of the professional association in an amount

[348] 43 T.C. at 595–96.

[349] *See Beneficial Corp. v. Commissioner*, 18 T.C. 396 (1952), *aff'd per curiam*, 202 F.2d 150 (3d Cir. 1953); *Dynamics Corp. of Am. v. United States*, 392 F.2d 241 (Ct. Cl. 1968). *See* Reg. §1.1552-1(b)(2).

[350] *See Sparks Nugget, Inc. v. Commissioner*, T.C. Memo 1970-74, *aff'd*, 458 F.2d 631 (9th Cir. 1972); Rev. Rul. 69-630.

[351] Citing former Reg. §1.1502-14, the IRS stated that the amounts treated as dividends were intercompany items, and eliminated them in computing the taxable income of the group. Under current Reg. §1.1502-13(f)(2)(ii), intercompany dividends are excluded, rather than eliminated, from the distributee's gross income.

[352] T.C. Memo 1970-74, *aff'd*, 458 F.2d 631 (9th Cir. 1972).

[353] T.C. Memo 1965-131, *aff'd sub nom.*, *Equitable Publ'g Co. v. Commissioner*, 356 F.2d 514 (3d Cir. 1966). *See also* FSA 200031007 (constructive dividend found when, in sham transaction, domestic corporation paid outside party for services and outside party subsequently paid similar amount to domestic corporation's foreign affiliate).

[354] The Tax Court relied on *Helvering v. Horst*, 311 U.S. 112 (1940). For other cases relying on *Horst* for the proposition that the controlling shareholder of a corporation is taxable on a distribution of corporate earnings made at the shareholder's behest to a third person for some purpose that the shareholder wishes to serve, even when that shareholder receives no economic gain, *see Byers v. Commissioner*, 199 F.2d 273 (8th Cir. 1952), *aff'g* 10 T.C.M. 200 (1951), and *Whitehead v. Commissioner*, 148 F.2d 718 (4th Cir. 1945).

[355] T.C. Memo 1982-660.

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equivalent to the §482 adjustment. The court found that, although the shareholders of the professional association had assigned their stock of the S corporation to some of their relatives, they were, in fact, the true owners of the stock, and that the main purpose of establishing the S corporation was to provide income for the relatives to whom the stock of the S corporation was transferred. Thus, the court concluded, the purpose of the intercorporate shift of funds was primarily to benefit the shareholders of the professional association and there was no corporate business purpose.

Example: A owns all of the stock of each of corporations X and Y. X performs services annually for Y; X keeps an open, non-interest-bearing account with respect to amounts owed by Y to X. Y pays on the account sporadically but never pays it off. Prior to A's sale of Y's stock, the intercompany account is cancelled for no consideration to X. X is considered to have made a constructive distribution to A in the amount of the open account and A is deemed to have contributed such amount to the capital of Y.

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V. Tax Treatment for Noncorporate Shareholders

A. *Taxability of Distribution to Shareholder*

1. *In General*

The amount of a distribution of property to a shareholder is the fair market value of the property distributed (reduced, but not below zero, by any liability assumed by the shareholder to which the property is subject) determined as of the date of distribution.[356] To the extent the corporation has earnings and profits, the amount distributed to the shareholder is a "dividend." Qualified dividend income is taxed as net capital gain under §1(h)(11).[357] Qualified dividend income generally means dividends received from a domestic corporation, although dividends from certain foreign corporations may also be considered qualified dividend income. A dividend received by a noncorporate shareholder that is not a qualified dividend is taxed as ordinary income. Any amount in excess of earnings and profits is treated as a return of capital to the extent of the distributee's basis in the distributee's stock.[358] The portion of a distribution in excess of both earnings and profits and stock basis is taxed as gain from the sale or exchange of the underlying stock and generally results in capital gain.[359]

2. *Qualified Dividend Income*

For tax years beginning after December 31, 2002, a noncorporate shareholder's "qualified dividend income" is taxable as net capital gain rather than ordinary income.[360]

"Qualified dividend income" generally means dividends received from a domestic corporation. The statutory definition also includes dividends received from a foreign corporation if one of the following criteria is met:

(a) the foreign corporation is incorporated in a U.S. possession;

(b) the foreign corporation is eligible for the benefits of an income tax treaty with the United States that includes an information-exchange program and that the IRS determines is satisfactory for the purposes of §1(h)(11); or

(c) the stock with respect to which the dividends are paid is tradable on an established U.S. securities market.[361]

The §1(h)(11) net capital gain treatment does not apply to dividends received from an organization that was tax exempt under §501 in either the tax year of the distribution or the preceding tax year.[362]

To be eligible for the capital gain treatment of dividends, a shareholder must hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the §246(c) ex-dividend date.[363] Capital gain treatment does not apply to the dividends on any share of stock if the taxpayer is obligated (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.[364]

Net capital gain treatment of dividends and the reduced net capital gain rates apply for purposes of the alternative minimum tax as well as the regular tax.[365] However, to the extent the qualified dividend income exceeds an amount equal to 10% (5% for preferred stock) of the taxpayer's adjusted basis in the underlying stock, any loss realized on a subsequent sale or exchange of the stock must be treated as long-term capital loss to the extent of that excess amount.[366]

Comment: The statutory language identifies these dividends as "extraordinary dividends" and refers to §1059(c) for the mechanics of identifying an extraordinary dividend (i.e., 10% of adjusted basis). As discussed in VII., below, classification of a dividend as an "extraordinary dividend" has significant tax implications for corporate shareholders. None of the other provisions of §1059 applies to individual shareholders, despite the common terminology and reference to §1059(c). Nevertheless, it is unclear whether the aggregation rules under §1059(c) apply in identifying "extraordinary dividends" in the individual shareholder context.

B. *Basis to Distributee*

The basis of property received in a §301 distribution by a distributee-shareholder is its fair market value determined as of the date of distribution.[367] If the shareholder assumes or takes the property subject to a liability, however, the amount of the distribution is reduced.[368] Nevertheless, the shareholder's basis for the property remains its fair market value.[369]

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356 §301(b).

357 §301(c)(1).

358 §301(c)(2).

359 §301(c)(3).

360 §1(h)(11).

361 §1(h)(11). *See* Notice 2003-79 (guidance on qualified foreign corporations and on §6042 information reporting requirements for distributions from such corporations), *modified and amplified by* Notice 2004-71 (extending rules to 2004 information reporting of distributions with respect to securities issued by foreign corporations), *and by* Notice 2006-3 (extending rules to 2005 and later years, with appropriate modifications to take into account changes made by the American Jobs Creation Act of 2004, Pub. L. No. 108-357); Notice 2003-69 (U.S. tax treaties deemed to satisfy requirements for treatment of dividends as "qualified dividend income"), *amplified and superseded by* Notice 2024-11 (updating list). *See also* PLR 200606021 (stock of foreign corporation registered under Securities Act of 1933 based on filing of Registration Statement on SEC Form S-3 is readily tradable on established U.S. securities market for §1(h)(11) purposes, but unregistered shares are not).

362 §1(h)(11)(B)(ii).

363 §1(h)(11)(B)(iii).

364 §1(h)(11)(B)(iii). (The wording of the last-mentioned restriction is borrowed from §246(c). Reg. §1.246-5 defines the phrase "substantially similar or related property," at least for purposes of §246(c). For further discussion of the regulation, see VI.C.5., below). *See* PLR 201129029 (for §1(h)(11), "net capital gain" equals net capital gain and "qualified dividend income," which excludes dividends to which the §246(c) requirements are not met).

365 §55(b)(3)(B), §55(b)(3)(C).

366 §1(h)(11)(D)(ii).

367 §301(d), §301(b)(3). *See also* Reg. §1.301-1(g), as amended by T.D. 9954, 86 Fed. Reg. 52,612 (Sept. 22, 2021), to update Reg. §1.301-1 to reflect statutory amendments made to §301(d) in 1988.

368 §301(b)(2).

369 §301(d). *See also* Reg. §1.301-1(g).

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Example: Corporation X distributes to shareholder S property that is subject to a liability of $30, has a fair market value of $150, and has an adjusted basis in X's hands of $50. The amount considered to be distributed to S is $120 ($150, the fair market value of the property, minus $30, the amount of the liability to which the property is subject). Assuming X has current and accumulated E&P both with positive balances in excess of $120, the entire $120 will be taxed as a dividend. S's adjusted basis in the property is $150 (its fair market value), and S's holding period for the property begins on the date of the distribution.

C. Holding Period of Property Distributed

The determination of a distributee's holding period in the distributed property is now uniform, beginning on the distribution date.[370]

[370] Before the repeal of §301(e) by the Tax Reform Act of 1986 (1986 TRA) (Pub. L. No. 99-514), the holding period of distributed property depended on whether the distributing corporation recognized gain on the distribution of appreciated property. This simplifying change follows the major reform in the 1986 TRA, requiring all gains to be recognized to the distributing corporation on the distribution of appreciated property. See VIII., below.

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VI. Dividends Received Deduction

A. Generally

The domestic DRD has been a staple of the corporate income tax since almost the beginning of the income tax law.[371] Its purpose is straightforward: to impose a single corporate income tax on the same domestic income. Without the DRD, domestic corporate income could be subjected to double corporate taxation; first when earned, and then when distributed to corporate shareholders. Of course, double taxation also occurs when corporate income is distributed directly to individual shareholders. However, the latter result has been accepted widely (if not universally) as a feature of the classical system of income taxation, in which corporations are taxed separately from their owners. At the other end of the spectrum, an integrated system of income taxation would attribute corporate earnings (undistributed, as well as distributed) and taxes to the shareholders. A less comprehensive system, partial integration (or dividend-relief) would grant relief to shareholders for distributed earnings only. The DRD achieves partial integration for intercorporate investment by granting dividend relief to distributions that stay within the corporate income tax system. Without relief of the DRD, the same earnings could be subject to more than two levels of taxation as distributions are made to corporate shareholders and then to individual shareholders.

Section 243 generally allows domestic corporate shareholders a deduction for a portion of dividends received from domestic corporations. The amount of the deductible portion is a function of the percentage of stock held by the corporate shareholder compared to the total shares outstanding.[372] This shareholder ownership percentage is determined by vote and value of the corporation's stock.[373] Section 1504(a)(4) preferred stock is not, however, included in determining the ownership percentage of a corporate shareholder for purposes of the DRD.[374]

B. Levels of DRD

There are three levels of DRD, scaled according to the degree of investment in the distributing corporation. The lowest level is for portfolio investors, the middle level is for direct investors, and the highest level is for controlling investors. For taxable years ending after December 31, 2017, corporate shareholders owning less than 20% of the distributing corporation (by vote and value) are allowed a 50% DRD,[375] corporate shareholders owning more than 20% of the distributing corporation (by vote and value) are allowed a 65% DRD,[376] and a corporate shareholder receiving dividends from another member of the same affiliated group generally is allowed to deduct 100% of the amount of the dividend received.[377] The deductions for dividends received by these types of corporate shareholders are 70%, 80%, and 100%, respectively for taxable years beginning before December 31, 2017.

The term "affiliated group" generally has the same meaning as it does for consolidated returns;[378] indeed, the 100% DRD is intended to mirror the consolidated return treatment of intercompany dividends, which are generally excluded from the distributee's gross income.[379] Dividends eligible for the 100% DRD are limited to distributions out of earnings and profits from post-1963 tax years for which the distributing and distributee corporations were members of the same affiliated group on every day of the year.[380]

C. Restrictions on the DRD

1. Generally

Although the DRD appears broad and straightforward, §246 limits its scope. Many of the limitations are common sense restrictions on taxpayers in situations in which application of the DRD would violate the purpose and intent of the deduction. For instance, §246 denies the DRD to corporate taxpayers receiving dividends from tax-exempt corporations and to corporate taxpayers receiving dividends from Federal Home Loan Banks since those dividends were potentially not subject to the first layer of taxation.[381] Section 246 also limits the aggregate amount of DRD taken by certain corporate shareholders, based on taxable income.[382] Section 246, moreover, imposes complex rules to hinder abuse of the DRD through restrictive holding period rules.[383]

2. Aggregate DRD Limitations

Generally, if a corporate shareholder claims a 50% DRD, the DRD may not exceed 50% of the shareholder's taxable income. For corporate shareholders claiming a 65% DRD, the DRD may not exceed 65% of taxable income.[384] In computing the limit, the percentage of taxable income is determined without regard to the deduction for net operating losses, the §199A deduction, the DRD, capital loss carrybacks, the §250 deduc-

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[371] For an historical account of the DRD, see Crosser, Laufer & Scott, *Dividends-Received Deduction and Net Operating Losses: Income Can Create a Loss!* 38 Oil & Gas Tax Q. 296 (1989).

[372] Of note, the DRD rules do not incorporate the constructive ownership rules of §318 in aggregating ownership. The ownership is based solely on the direct ownership of each corporation.

[373] §243(c)(2).

[374] *See* CCA 201152016. A corporate shareholder that owns only nonvoting preferred stock, is likely entitled to a 70% DRD for dividends received prior to December 31, 2017, and 50% for dividends received after December 31, 2017. *See* CCA 201152016 at n.8.

[375] *See* §243(a)(1).

[376] *See* §243(c)(1).

[377] *See* §243(a)(3). However, §243(b)(2) provides that a corporation in an affiliated group may not claim the 100% DRD for dividends received from other members of the group unless the group is consistent in its treatment of foreign taxes paid as either a credit or a deduction.

[378] §243(b)(2). "Affiliated group" has the meaning given by §1504(a) except that §1504(b)(2) and §1504(c) do not apply.

[379] *See* Reg. §1.1502-13(f)(2)(ii). The exclusion only applies, however, to the extent there is a corresponding negative adjustment under Reg. §1.1502-32 in the distributee's basis in the distributing member's stock.

[380] §243(b)(1)(B).

[381] §246(a).

[382] *Michigan Memorial Park, Inc. v. United States*, No. 4:12-cv-12023-GAD-MKM, 2013 BL 5203 (E.D. Mich. Jan. 8, 2013) (distributions from perpetual care trust taxed as ordinary income to corporation because the distributions related to compensation for services). For further discussion, see VI.C.2., below.

[383] For further discussion, see VI.C.3. through VI.C.5., below.

[384] §246(b)(1).

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tions,[385] basis reduction under §1059,[386] and the dividends paid deduction on public utility preferred stock.[387] For corporate shareholders claiming both a 50% and a 65% DRD, the limit is computed first with respect to the latter.[388]

Example: Corporation X has $50,000 of taxable income before the DRD. Included in taxable income is $60,000 of dividends received from Y, a corporation in which X owns 25% of the stock. X, therefore, is eligible for the 65% DRD. The tentative DRD is $39,000 (65% of $60,000), but the allowable DRD is limited to $32,500 (65% of $50,000). Taxable income after the DRD is $17,500 ($50,000 – $32,500).

The taxable income limit does not apply, however, if the DRD either creates or increases a net operating loss.[389] This exception has been described as producing a "cliff" or "notch" effect.

Example: The facts are the same as above, except that taxable income before the DRD is $30,000. The allowable DRD is the same as the tentative DRD ($39,000), because taking into account the tentative DRD creates an NOL of $9,000 ($30,000 – $39,000).

Example: In the two examples above, X had taxable income before the DRD of $50,000 and $30,000, respectively. For X, the basic taxable income limit begins to apply when taxable income before the DRD falls below $60,000 (total dividend income). The basic limit continues to apply until taxable income before the DRD falls to $39,000, beyond which point it ceases to apply at all. At $39,000, the allowable DRD is $25,350 (65% of $39,000). At $38,999, the allowable DRD is $39,000 (65% of $60,000), because subtracting $39,000 from $38,999 produces an NOL of $1. If taxable income before the DRD equals $39,000, the challenge for X is to find a dollar of deductions (or defer a dollar of income) to obtain an additional DRD of $13,650 ($39,000 – $25,350).

Comment: This limitation is mechanical in that it can be computed from items reported on the taxpayer's Form 1120, Schedule C.

3. DRD Holding Period Rules

Under §246(c)(1)(A), a corporation is not entitled to a DRD unless the corporation has held the dividend-paying stock for more than 45 days during the 91-day period beginning on the date that is 45 days before the date on which such stock becomes ex-dividend with respect to such dividend.[390] That is, a corporation is not entitled to a DRD if the corporation's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the corporation becomes entitled to receive the dividend.

Practice Point: The declaration of an ex-dividend date is a procedure of a stock exchange that is used to prevent misunderstandings between parties selling shares as to who will be the recipient of dividends paid after the contract for sale is entered into. For example, the New York Stock Exchange normally sets the ex-dividend date at four days before the record date to allow for corporate record keeping changes so that the holder on the record date will be the same as the holder on the ex-dividend date.[391]

With respect to dividends received on preferred stock that are attributable to a period or periods aggregating in excess of 366 days, the stock must be held for more than 90 days during the 181-day period beginning on the date that is 90 days before the date on which such stock becomes ex-dividend with respect to the dividend in order for the taxpayer to receive a DRD.[392]

A taxpayer also is not entitled to a DRD to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.[393] This statutory provision has been interpreted extensively through regulations, as discussed further below.

Practice Point: Note that a shareholder is not entitled to §1(h)(11) treatment of dividends unless the shareholder meets the §246(c) holding period requirements (but substituting 60 days for 45 days and a 121-day period for the 91-day period); and a shareholder is not entitled to §1(h)(11) treatment to the extent the shareholder "is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property."[394]

4. Suspended Holding Periods

The lower effective tax rate (and higher return on investment) provided by the DRD has spawned an assortment of dividend-capture strategies.[395] Corporate cash managers want the higher return without market risk that these investments may provide. To minimize market risk during the required holding periods, aggressive dividend-capture strategies employ a variety of hedging techniques. The backbone of the government's defense against overly protective hedging techniques is a set of rules that suspend the running of holding periods, freezing them short of the statutory minimum needed to qualify for the DRD.[396]

The rules set aside holding periods if the corporate shareholder:

(1) has an option to sell substantially identical stock or securities;

[385] *See* AM 2024-002 (advising on how the §246(b) limitation applies to former §250 (2024) deductions).

[386] For further discussion on basis reduction under §1059, see VII., below.

[387] §246(b)(1).

[388] §246(b)(3). Prior to the TCJA, similar limitations applied to corporate shareholders taking a 70% or 80% DRD.

[389] §246(b)(2).

[390] §246(c)(1).

[391] *See* GCM 38721 (May 18, 1981).

[392] §246(c)(2).

[393] §246(c)(1)(B).

[394] §1(h)(11)(B)(iii). For further discussion of the §1(h)(11) treatment of dividends, see II.C., above.

[395] Willens, *New Decision Expands Availability of Dividends Received Deduction*, 74 J. Tax'n 276 (1991).

[396] §246(c)(4).

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(2) is obligated to sell substantially identical stock or securities;

(3) has made a short sale of substantially identical stock or securities that is still open;

(4) has granted certain options to buy substantially identical stock or securities; or

(5) has diminished its risk of loss by holding one or more positions with respect to substantially similar or related property.[397]

The IRS has stated that these rules do not apply to traditional mandatory redemption rights, which are common in the terms of many preferred stocks. However, the IRS cautioned that this exception is construed narrowly so that it does not extend to instruments that afford the holders the right to a fixed payment on a specified date and allow the holders to sue the creditors to enforce this right.[398]

Example: Corporation G acquired stock in corporation H on January 1, Year One, and sold it on March 1, Year One, a period of 59 days (day of acquisition ignored but not day of disposition, pursuant to Reg. §1.246-3(d)(1)). On February 15, Year One, H paid a dividend to G. From January 15, Year One, to February 7, Year One, a period of 23 days, G held a put option with respect to its H stock. G's nominal holding period of 59 days is reduced by 23 days, meaning that G's holding period does not exceed 45 days, thus rendering G ineligible for the DRD.

In an effort to explain the complicated rules suspending holding periods, Treasury published final regulations in 1995, as discussed below.

5. *Regulations Regarding Suspension of Holding Periods*

a. *General*

Section 246(c)(4)(C) tolls the holding period for any period during which, "under regulations prescribed by the Secretary, a taxpayer has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property." The statutory phrases "diminished risk of loss" and "substantially similar or related property" proved ambiguous, so Treasury issued regulations to help define and apply these terms for purposes of §246(c)(4)(C).[399]

b. *Basic Definitions*

The regulations begin by setting forth definitions of the key statutory phrases. Reg. §1.246-5(b)(1) provides that the term "substantially similar or related property" (SSRP) is applied according to the facts and circumstances in each case.[400] However, the following basic rules are provided.

Property is substantially similar or related to stock when:

(1) the fair market values (FMVs) of the stock and the property primarily reflect the performance of:

(A) a single firm or enterprise;

(B) the same industry or industries; or

(C) the same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign currency exchange rates; and

(2) changes in the FMV of the stock are reasonably expected to approximate, directly or inversely, changes in the FMV of the property, a fraction of the FMV of the property, or a multiple of the FMV of the property.

Next, the regulations define "diminished risk of loss." Under Reg. §1.246-5(b)(2), a taxpayer has diminished its risk of loss on its stock by holding positions with respect to SSRP if changes in the FMV of the stock and the positions are reasonably expected to vary inversely.

The regulatory definitions of SSRP and "diminished risk of loss" presented two additional ambiguous terms: "position" and "reasonably expected." According to the regulations, a taxpayer holds a "position" in SSRP if it holds an interest (including a futures or forward contract or an option) in property or any contractual right to a payment, whether or not severable from stock or other property. It does not include traditional equity rights to demand payment from the issuer, such as rights traditionally provided by mandatorily redeemable preferred stock.[401]

"Reasonable expectations" are those of a reasonable person based on all the facts and circumstances on the later of the time the stock is acquired or the positions are entered into and include all explicit or implicit representations made with respect to the marketing or sale of the positions.[402]

Example 1: Corporation X and corporation Y are both audio parts manufacturers. The FMVs of X stock and Y stock primarily reflect the same industry. However, the values of X and Y common stock are affected by factors beyond the general growth of the industry. These might include corporate management decisions or corporate capital structure differences. Thus, changes in the FMV of X common stock are not reasonably expected to approximate FMV changes of Y common stock. Therefore, X common stock and Y common stock are not SSRP.[403]

Example 2: Corporation C and corporation D hold gold as their primary asset. Historically, changes in the FMV of

[397] §246(c)(4). *See* Reg. §1.246-5, discussed below. *See also* FAA 20121201F, FAA 20121202F (taxpayers were not eligible for DRD because under terms of transaction they would receive amounts equal to their purchase price for shares upon redemption and, thus, diminished risk of loss).

[398] Rev. Rul. 94-28 (corporate purchaser's right to principal upon retirement at maturity of instruments that paid fixed amount on specified date was option to sell (or contractual obligation to sell) instruments for purposes of §246(c)(4)(A); purchaser's holding period, therefore, was suspended under §246(c)(4)).

[399] *See* Reg. §1.246-5.

[400] *See* CCA 201827011 (taxpayer's possession of units in ETF designed and managed to correspond to performance of Index, was considered to be SSRP to short positions taxpayer held directly in Index, and reduced risk of loss in ETF units, resulting in reduction of the holding period of ETF units such that taxpayer was not eligible for dividends received deduction on ETF dividends).

[401] Reg. §1.246-5(b)(3). *See also* Rev. Rul. 94-28 (holder had right to fixed payment on specified date and could sue as creditor to enforce right).

[402] Reg. §1.246-5(b)(4).

[403] Reg. §1.246-5(d) *Ex.* 1.

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C common stock approximated changes in the FMV of D common stock. When corporation Z purchases C common stock and sells short D common stock, Z has diminished its risk of loss. This occurs because the FMVs of C and D common stock primarily reflect the performance of the same specific commodity and changes in their respective values are reasonably expected to approximate one another. It is reasonably expected that the short position in D stock will vary inversely with the value of the C stock. Thus, the two stock positions are SSRP within the meaning provided in the regulations.[404]

Comment: As explained below, the definition of SSRP set forth above does not necessarily mean that any property is SSRP merely because changes in its value can reasonably be expected to approximate those of the stock held by the taxpayer. For example, changes in the fair market value of a diversified portfolio of stocks can be expected in some circumstances to approximate changes in the value of a broadly based stock index, but this does not necessarily make the index SSRP to the stock portfolio. On the other hand, once it is established that a given position is SSRP to the stock held by the taxpayer, a short position with respect to such position automatically diminishes the risk of loss from the stockholdings.

Practice Point: The 1993 proposed regulations contained an example of a taxpayer holding nonparticipating, fixed-term preferred stock offset by a short position in interest rate futures (based on Treasury securities). The example concluded that fluctuations in interest rates could reasonably be expected to affect the values of the two positions inversely in approximately the same amounts. The example was withdrawn from the final regulations after commentators pointed out that in some cases the FMV of the preferred could be affected by factors other than interest rate fluctuations (e.g., changes in the issuer's credit rating). The preamble to the final regulations cautions, however, that in this situation the interest rate futures position may or may not be SSRP depending on the facts and circumstances. Taxpayers should be advised, therefore, that the IRS will scrutinize any positions in what are technically equity interests but have substantial debt-like characteristics that are offset by short interest rate futures.

c. Substantial Overlap in Portfolio Stock

Probably the most difficult issue in applying these rules is determining the extent to which short positions with respect to stock indices fulfill the requirements of SSRP. Fluctuations in the value of the stock of any corporation reflect both risks that are inherent in the business operations of that particular corporation and risks that are relatively common to all business entities. Thus, a given company's profits may rise (or fall) dramatically during a period in which the major widely based stock indices (Dow, S&P 500, NYSE Composite) are relatively stable.

There are two categories of risks that may affect the value of a stock or a portfolio of stocks. First, there are risks that reflect those factors to which a given corporation is peculiarly sensitive. These are termed "nonsystematic," as distinguished from "systematic" risks (which reflect factors that affect the performance of the stock market as a whole). Nonsystematic risk can be reduced through diversification. A taxpayer the value of whose stock holdings reflects nonsystematic risk generally is not able to hedge such risk effectively by acquiring a short position in any stock index RFC. Futures trading in stock indices is limited to those indices that are broadly based (e.g., MMI, S&P 500, NYSE Composite), fluctuations in the value of which reflect only systematic risk. Exchange-traded options are available, however, on more narrowly based indices, and, in the over-the-counter market, an investor can obtain a short position on indices limited to stocks of corporations in a particular industry.

FAA 20131902F advised that S&P 500 options held by the taxpayer would be treated as a position held by the related party subsidiaries rule under Reg. §1.246-5(c)(6). The holding period of the subsidiaries' equity portfolio was limited pursuant to §246(c)(4)(C).

Comment: The proposed regulations would have treated two portfolios of stock as SSRP when changes in their FMVs were reasonably expected to approximate each other. Commentators suggested that the proposed rule did not give effect to the legislative history. The legislative history of the relevant statutory provisions stated that the SSRP standard is not satisfied merely because the taxpayer is an investor with diversified holdings and acquires an RFC or option on a stock index to hedge general market (i.e., systemic) risk.[405] It was suggested that even if changes in value of the two positions were expected to approximate each other, the SSRP standard should be met only if the portfolios substantially overlap. This suggestion was adopted in the final regulations, and is embodied in the "Special Rules" of Reg. §1.246-5(c)(1)(i) through (iv).

If a taxpayer holds stock in A, B, C, and D corporations and also holds a short position in an index whose value reflects predominantly the values of stocks B, C, and D, the short position seems clearly to be SSRP; not only will changes in the values of the taxpayer's stockholdings in such a case reasonably be expected to approximate, inversely, changes in the value of the index, but there is substantial overlap between stocks B, C, and D. However, if the taxpayer also has substantial investments in half a dozen more stocks whose values are not represented in the index, it may be less clear that the index position meets the SSRP test, even if changes in the values of the stock held and the index position approximate each other because of their sensitivity to certain economic factors. The IRS and Treasury concluded that this problem could not be resolved by examples, and that it required clearly stated rules of general application.

The regulations, therefore, apply a mechanical test to the determination of substantial overlap. In the following discussion, the stockholdings of the taxpayer are referred to as the SP (shareholder's position), and the stock whose value is represented in the index is referred to as the IP (index position).

(1) Index Positions Representing the Values of 20 or More Stocks

An index position reflecting the value of 20 or more stocks of unrelated issuers (i.e., a position reflecting the value of a portfolio) is SSRP to the stocks held by the taxpayer only if the

[404] Reg. §1.246-5(d) *Ex.* 2.

[405] *See* T.D. 8590, 60 Fed. Reg. 14,636 (Mar. 20, 1995).

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position and the taxpayer's holding substantially overlap as of the most recent "testing date."[406] A "testing date" includes: (1) any day on which the taxpayer buys or sells any stock if the FMV of the stock or the FMV of the SSRP is reflected in the position; (2) any day on which the taxpayer changes the position; or (3) any day on which the composition of the position changes.[407] A position may be SSRP to a taxpayer's entire stockholdings or a portion of the stockholdings.

To determine whether "substantial overlap" exists, a "subportfolio" is assembled. The "subportfolio" includes each stock that is both held by the taxpayer and represented in the IP. Each stock in the subportfolio is assigned a value equal to the lesser of the FMV of the stock represented in the position and the FMV of the stock in the taxpayer's holdings. Once the stocks and values listed in the subportfolio have been determined, the ratio value of subportfolio-to-value of stocks represented in the IP must be determined. If this ratio equals or exceeds 70%, there is substantial overlap and the IP is SSRP with respect to the SP. If this calculation shows no overall substantial overlap, the values represented in the IP are reduced by a percentage until substantial overlap exists with respect to a portion of the holdings. If the revised subportfolio-to-IP ratio is 70% or more, there is substantial overlap to the extent of 100% less the percentage reduction described.

> *Example:* Assume the SP contains holdings of the stocks of corporations A through T, with the exceptions of I and O (18 stocks in all) with an FMV of $4,200. The IP represents the values of the stock of all the corporations A through T (20 stocks in all) with an FMV of $6,750. The subportfolio with 18 stocks represented has an FMV of $4,100. The ratio of subportfolio value to index portfolio value is 60.74% (4100/6750), and the substantial overlap test is not satisfied. Next, the values of all the stocks represented in the IP must be reduced, and a revised subportfolio is calculated.[408] Assume the IP values are reduced by 20%. The sum of the recomputed FMVs of each of the stocks in the IP is $5,400. Recomputing the subportfolio (taking the lesser of the individual FMVs of the IP stocks and the FMVs of the SP) results in a subportfolio value of $3,780. The subportfolio-to-IP ratio is now exactly 70% (3780/5400). Thus, the IP is SSRP with respect to 80% of the taxpayer's stockholdings.[409]

Comment: In view of the considerable diversification of the stock position (18 issues) and of the stocks represented in the index, it can be assumed that changes in value of each will reflect general market (systematic) risk to a considerable degree. In this situation, the taxpayer would be well advised to select another index with a comparable degree of diversification to hedge the stockholdings.

The important point made by these special rules is that even if changes in the value of a stock portfolio and an index can reasonably be expected to approximate each other, the index property is not automatically SSRP to the stock unless there is substantial overlap. Thus, systematic risk can be effectively hedged without loss of the DRD.

(2) Index Positions Representing Less than 20 Stocks

The regulations also supply a rule for nonportfolio (i.e., indices with fewer than 20 stocks represented) positions. A position that represents the value of more than one, but less than 20, stocks is treated as a separate position with respect to each of the stocks the value of which the position reflects.[410] Thus, if the taxpayer holds shares of corporations X, Y, and Z, and the nonportfolio (narrowly based index) position reflects the values of stocks Y, Z, and M, the degree of overlap presumably is determined solely on the basis of the FMV of the shares held and of the stocks represented in the index on a stock-by-stock basis. If the taxpayer holds 100 shares of Y but the index position reflects the value of only 10 shares of Y, the index position is SSRP with respect to 10% of the Y stock held by the taxpayer.

d. Anti-Abuse Rule

Reg. §1.246-5(c)(1)(vi) provides an "anti-abuse" rule under which, notwithstanding the mechanical special rules explained above, a position that reflects the value of more than one stock is SSRP to "the appropriate portion of the taxpayer's stock holdings" if:

> (1) changes in the value of the position or the stocks reflected in the position are reasonably expected virtually to track (directly or inversely) changes in the value of the taxpayer's stock holdings, or any portion of such holdings and other positions of the taxpayer; and
>
> (2) the position is held or acquired as part of a plan a principal purpose of which is to obtain tax savings (including deferral) the value of which is significantly in excess of the expected pre-tax economic profits from the plan.

Note: Reg. §1.246-5(d), Example 3, from which the above discussion of the "substantial overlap" special rules is drawn, indicates that the percentage of overlap derived by applying the formula under the special rules may be increased by applying the anti-abuse rule when appropriate.

e. Options, Stacking Rule, Guarantees, and Hedges

Apart from the special rules set forth above, the regulations provide a number of other general rules.

> (1) A substantially out-of-the money option to sell does not diminish the taxpayer's risk of loss on its stock "unless the option is held as part of a strategy to substantially offset changes in the fair market value of the stock."[411] The regulations do not indicate what such a strategy might be.
>
> (2) Notwithstanding the definitions of SSRP and "diminished risk of loss" set forth above, the regulations provide that the following transactions involving convertible preferred stock or convertible debentures are treated as diminishing the taxpayer's risk of loss:

[406] Reg. §1.246-5(c)(1)(ii).

[407] Reg. §1.246-5(c)(1)(iv).

[408] The regulations require that the largest percentage of the IP that results in substantial overlap "is substantially similar or related to the Subportfolio determined with respect to that percentage of the position." Reg. §1.246-5(c)(1)(iii)(C).

[409] Reg. §1.246-5(d) *Ex.* 3.

[410] Reg. §1.246-5(c)(1)(v).

[411] Reg. §1.246-5(c)(2)(i).

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(i) a short sale of common stock while the taxpayer holds convertible preferred of the same issuer and the price changes of the convertible preferred and the common stock are related;

(ii) a short sale of a convertible debenture while the taxpayer holds convertible preferred stock into which the debenture is convertible or common stock; or

(iii) a short sale of convertible preferred stock while the taxpayer holds common stock.[412]

(3) The regulations provide a "stacking rule." If the taxpayer diminishes risk of loss by holding a position in SSRP that diminishes the risk of loss on only a portion of the stock held by the taxpayer, the holding period of the shares having the shortest holding period is reduced.[413]

(4) The regulations provide that a guarantee, surety agreement, or similar arrangement that will substantially offset decreases in the FMV of the taxpayer's stock is treated as a position in SSRP to the stock.[414]

(5) Hedges are counted only once. The regulations state that a position (position H) established as a hedge of one outstanding position, transaction, or obligation (position P) is not treated as diminishing the risk of loss from another position (position P2) held by the taxpayer. The regulations do not provide identification requirements for determining which position is position P and which is position H, but state that "substantial deference will be given to the relationships that are established in [the taxpayer's] books and records at the time the position is entered into."[415]

Example: Corporation X owns a $50 million portfolio of stocks that would substantially overlap with a $50 million regulated futures contract (RFC) on a commonly used index. X hedges its $50 million portfolio of stocks by entering into a $50 million short stock position in an RFC on January 15 with a March delivery date. On the same date, X also enters into a $30 million long position with respect to the same RFC with a June delivery date. It is established from a January 15 entry in X's books and records that the long and short index RFCs were intended to offset one another. Under these circumstances, $30 million of the short position in the RFC is not treated as diminishing the risk of loss from the stock portfolio. Instead, the long and short RFC positions are treated as a hedging transaction, as appropriate, with respect to the $30 million long position. The remaining $20 million short RFC position is treated as diminishing the risk of loss on the portfolio by holding a position in SSRP. The substantial overlap rules of Reg. §1.246-5(c), discussed above at VI.C.5.c., determine how much of the portfolio is subject to the hedging rules percentage.[416]

f. Use of Related Persons or Pass-Through Entities

The regulations provide that positions of a party related to the taxpayer (within the meaning of §267(b) and §707(b)(1)) are treated as held by the taxpayer if they are held with a view to avoiding the application of these regulations. Furthermore, a taxpayer is treated as diminishing its risk of loss by holding SSRP if it holds an interest in, or is the beneficiary of, a pass-through entity, intermediary, or other arrangement with a view to avoiding the application of these regulations.[417]

g. Notional Principal Contracts

Payments due from the counterparties to a notional principal contract (NPC) are usually netted. Reg. §1.246-5(c)(7) provides that for purposes of these regulations, payments under NPCs are considered separately. Therefore, if a taxpayer is treated as receiving payments under an NPC when the fair market value of the taxpayer's stock declines, there is a diminution of risk of loss from holding a position in SSRP regardless of the netting of payments.

D. Dividends Received from Foreign Corporations

1. General

Although the §243 dividends received deduction (DRD) is specifically limited to amounts received as dividends from "domestic" corporations,[418] there are several instances in which a corporation is allowed a deduction for a dividend received from a foreign corporation. Section 243(e) provides a DRD for dividends received from a foreign corporation that has succeeded to U.S. earnings and profits. Section 245 provides a DRD for the U.S.-source portion of dividends received from wholly owned foreign subsidiaries and certain dividends received from a former FSC. In addition, §245A, applicable to tax years beginning after December 31, 2017, provides a DRD for the foreign-source portion of dividends received from certain foreign corporations. Each of these is discussed further in this section.

2. Dividends Received from a Successor Foreign Corporation

Section 243(e) provides a DRD with respect to dividends received from a foreign corporation that has succeeded to U.S. earnings and profits. The successor foreign corporation must

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[412] Reg. §1.246-5(c)(2)(ii).

[413] Reg. §1.246-5(c)(3).

[414] Reg. §1.246-5(c)(4). *See also* Rev. Rul. 94-28; FAA 20121201F, FAA 20121202F (citing Reg. §1.246-5(c)(4), Chief Counsel's Office advised that where guarantees offset decreases in fair market value of stock, guarantees are substantially similar or related property that diminish taxpayer's risk of loss; taxpayer is not eligible for DRD).

[415] Reg. §1.246-5(c)(5).

[416] Reg. §1.246-5(d) *Ex.* 4.

[417] Reg. §1.246-5(c)(6). *See* FAA 20131902F (where X knew that positions offset domestic equity portfolio accounts of related party subsidiaries and, in fact, entered into option strategy in order to offset risk of loss in equity portfolios, Chief Counsel's Office advised that options held by X are treated as position held by related party subsidiaries pursuant to Reg. §1.246-5(c)(6); holding period of subsidiaries' equity portfolio is limited pursuant to §246(c)(4)(C), resulting in denial of portion of X's deduction claimed under §243). *See also* CCA 201827011 (although decided on general rule of Reg. §1.246-5(b)(1), taxpayer's acquisition of units in Index ETF that constituted regulated investment company, which effectively offset taxpayer's short position in Index itself could implicate second anti-abuse rule of Reg. §1.246-5(c)(6) to deny taxpayer's dividends received deduction as regulated investment company qualifies as "pass through entity" for purposes of anti-abuse rule).

[418] *See* §243(a).

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keep separate accounts for the U.S. earnings and profits.[419] The regulations pertaining to §243(e) provide examples of the computation of the permissible DRD.[420]

Note that the restrictions on the availability of the DRD, found in §246, apply to §243(e). These restrictions are discussed in detail in VI.C., above.

3. *U.S. Source Portion of Dividends Received from Certain Foreign Corporations*

Section 245(a) provides that if a domestic corporate shareholder owns 10% or more of a foreign corporation determined by vote and value and receives a dividend from the foreign corporation, the domestic shareholder may take a DRD for the portion of the dividend that represents U.S. sourced income. This rule does not apply to PFICs. The percentage amount of the DRD derives from the general ownership specifications of §243.[421] Section 245(a) provides definitions and mechanical rules for determining the DRD allowable, as well as references to subpart F for related definitions and rules.

Note that the restrictions on the availability of the DRD, found in §246, apply to §245(a). These restrictions are discussed in detail in VI.C., above.

4. *Certain Dividends Received from Wholly Owned Foreign Subsidiaries*

Section 245(b) allows a DRD for dividends received from a domestic corporation's wholly owned foreign corporation if all of the foreign corporation's gross income from all sources is effectively connected with the conduct of a trade or business within the United States. Although the eligibility of the dividends is limited, all eligible dividends are 100% deductible by the domestic corporation.[422]

Note that the restrictions on the availability of the DRD, found in §246, apply to §245(b). These restrictions are discussed in detail in VI.C., above.

5. *Certain Dividends Received from a Former FSC*

Section 245(c)(1)(A) provides a 100% DRD for a dividend received by a domestic corporation from another corporation to the extent that the distribution is out of earnings and profits attributable to foreign trade income for a period during which the other corporation was a FSC (foreign sales corporation). Section 245(c)(1)(B) provides a DRD for any dividend received by a U.S. corporate shareholder from another corporation that was distributed out of E&P attributable to effectively connected income of such other corporation while it was a FSC. For tax years beginning after December 31, 2017, the §245(c)(1)(B) DRD is 65% if the other corporation is 20% owned (by vote and value) by the dividend recipient and 50% if the dividend recipient owns less than 20% of the other corporation.[423]

Note that the 2000 FSC Repeal and Extraterritorial Regime Act repealed the FSC provisions.[424] Note also that the restrictions on the availability of the DRD, found in §246(a) and (c), apply to §245(c). These restrictions are discussed in detail in VI.C., above.

6. *Foreign-Source Portion of Dividends Received from Certain Foreign Corporations*

Effective for distributions made after December 31, 2017, the TCJA added §245A to the Code pursuant to which U.S. C corporations that are United States shareholders (as defined in §951(b)) and are not regulated investment companies (RICs) or real estate investment trusts (REITs) may claim a 100% DRD in an amount equal to the foreign-source portion of a dividend received from a "specified 10-percent owned foreign corporation."[425]

To apply similar tax treatment to cash dividends from CFCs and §956 amounts attributable to U.S. investment, Reg. §1.965-1(a) allows a corporate U.S. shareholder to first calculate its §956 amount and then reduce that amount by the §245A as if the §956 amount were hypothetically distributed to the U.S. shareholder.

Practice Point: Although relief under §245A helps to avoid some disparities between cash dividends and §956 deemed dividends, §245A does not apply to hybrid dividends (see VI.D.6.g., below). Therefore, the availability of §245A may not be known at the time of a pledge or guarantee because the determination of whether the §956 deemed dividend is a hybrid dividend will not be made until the close of the U.S. shareholder's tax year. For example, a U.S. shareholder may enter into a loan agreement during the calendar year and pledge the stock of a wholly owned CFC as part of the loan agreement. If the CFC makes a distribution to the U.S. shareholder following the pledge before the end of the year, the distribution will not give rise to a §956 inclusion amount if §245A applies to distribution. Because the measurement date for a "hybrid deduction account" (see below) is at the close of the tax year, it may later be determined that the distribution is a hybrid dividend and the amount could be determined to be a §956 inclusion amount. Taxpayers wishing to avoid this potential trap for the unwary should continue to follow the §956 safe harbors regarding CFC stock pledged.

For a more detailed discussion of §956, see 6260 T.M., *CFCs — Investment of Earnings in United States Property* (Foreign Income Series).

a. *Specified 10% Owned Foreign Corporation*

For purposes of §245A, a specified foreign corporation is any foreign corporation with a domestic corporation as a shareholder, other than a corporation that is a passive foreign invest-

[419] Reg. §1.243-3(b). Moreover, §243(e) does not apply to dividends paid out of earnings and profits accumulated (i) by a corporation organized under the China Trade Act, 1922, (ii) by a domestic corporation during any period with respect to which such corporation was exempt from taxation under §501 (relating to certain charitable, etc. organizations) or §521 (relating to farmers' cooperative associations), or (iii) by a domestic corporation during any period to which §931 (relating to income from sources within possessions of the United States), as in effect for tax years beginning before January 1, 1976, applied. *See* Reg. §1.243-3(a)(2).

[420] *See* Reg. §1.243-3(d).

[421] §245(a)(1).

[422] §245(b)(1). *But see* CCA 201320014 (DRD denied to domestic corporation's dividend receipt from foreign RIC under substance over form doctrine).

[423] §245(c)(1)(B).

[424] Pub. L. No. 106-519.

[425] §245A(a).

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ment company with respect to the shareholder and is not a controlled foreign corporation.[426]

> *Example:* Corp X is a foreign corporation more than 75% of whose gross income is passive income within the meaning of §1297(a)(1) and is therefore a PFIC. The stock of Corp X is owned 30% by U.S. C corporation USCo, and 5% each by 14 unrelated U.S. and foreign individuals. Therefore, Corp X is not a CFC and dividends it pays to USCo will not qualify for the §245A DRD. Assume instead that, with respect to the Corp X stock not owned by USCo, U.S. individual A owns a 25% interest and the remaining 45% of Corp X's outstanding stock is owned 5% each by nine unrelated individuals. In that case Corp X would be a CFC and dividends it paid to USCo — but not to A, an individual — would be eligible for the DRD.

Section 245A provides Treasury a broad grant of regulatory authority, and specifically identifies regulations for the treatment of U.S. shareholders owning stock of a specified 10% owned foreign corporation through a partnership.[427]

b. Foreign-Source Portion of Dividends

The §245A deduction is equal to the "foreign-source portion" of the dividend. The foreign-source portion of any dividend from a specified 10% owned foreign corporation is an amount that bears the same ratio to that dividend as (A) the "undistributed foreign earnings" of the corporation bear to (B) the total undistributed earnings.[428] Undistributed foreign earnings are the portion of the "undistributed earnings" attributable neither to income effectively connected with the conduct of a U.S. trade or business and subject to tax under chapter 1 of the Code, nor to dividends received from a domestic corporation at least 80% of the stock of which is owned by the specified 10% owned foreign corporation.[429] Undistributed earnings are the earnings and profits (E&P) of the specified 10% owned foreign corporation computed under §964(a) and §986 as of the close of the taxable year in which the dividend is distributed unreduced by any dividends distributed during that taxable year.[430]

c. Holding Period

A one-year — or more precisely, a 366-day — holding period is required for the §245A DRD. The U.S. shareholder must have held the shares of stock of the distributing corporation for more than 365 days during the 731-day period beginning on the date that is 365 days before the date on which the shares become ex-dividend.[431] The shareholder is treated as holding the stock for any period only if, at all times during the holding period, the specified 10% owned foreign corporation was a specified 10% foreign corporation, and only if the taxpayer was a U.S. shareholder with respect to the specified 10% foreign corporation.[432]

d. Foreign Tax Credit

Neither a foreign tax credit nor a deduction is available for foreign taxes paid with respect to a dividend for which a §245A DRD is allowed.[433] The foreign taxes covered include not only foreign taxes paid on the dividend-paying foreign corporation's earnings, which used to be eligible for a foreign tax credit under former §902, but also dividend withholding taxes that might otherwise be eligible for foreign tax credits under §901.

Section 904(b)(4) was added to coordinate the foreign tax credit limitation with the §245A DRD. It provides that, for purposes of the foreign tax credit limitation under §904(a), a corporate U.S. shareholder of a specified 10% owned foreign corporation must determine its taxable foreign-source income without regard to:

- the foreign-source portion of any dividend received from the specified 10% owned foreign corporation; and
- any deductions properly allocable or apportioned to income (other than amounts includible under §951(a) or §951A(a)) with respect to stock of the specified 10% owned foreign corporation, or stock of the specified 10% owned foreign corporation to the extent income with respect to that stock is other than amounts includible under §951(a)(1) or §951A(a).[434]

Thus, the DRD-eligible foreign source portion of any dividend from a specified 10% owned foreign corporation is removed from both the numerator and the denominator of the 10% U.S. corporate shareholder's foreign tax credit limitation formula.

As discussed in VI.D.1., above, the §245A DRD applies to distributions made after December 31, 2017, while TCJA amendments to §78, providing that amounts treated as dividends under §78 do not qualify for the §245A DRD, became effective for tax years of foreign corporations beginning after December 31, 2017. For a taxpayer with a fiscal year foreign subsidiary, this mismatch of effective dates created a window during which §245A was in effect, but amendments to §78 were not, which would have allowed the taxpayer to deduct a §78 deemed dividend and also claim a foreign tax credit. Treasury tried unsuccessfully to close that window in June 2019 by amending Reg. §1.78-1(a) to provide that an amount treated as

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426 §245A(b).

427 §245A(g).

428 §245A(c)(1). The state income tax treatment for dividends received deductions under §245A varies as some states will not allow a deduction for foreign dividends received. Also note, the §301 rules still apply in that if a distribution from a specified foreign corporation exceeds accumulated earnings and profits, the distribution will be a return of capital and then once the shareholder's basis is exceeded it is taxed as capital gain.

429 §245A(c)(3), §245(a)(5)(A), §245(a)(5)(B) (the amount of dividends received from an 80% owned domestic corporation is determined without regard to whether the corporation is a REIT or a RIC). *See also* §245(a)(12); PLR 202504005 (multinational taxpayer was able to combine E&P and deficit pools under §381 transaction to qualify for the 100% DRD under §245A).

430 §245A(c)(2).

431 *See* §246(c)(5)(A). *See also* §246(c)(1)(A). The special holding period requirement for preferred stock in §246(c)(2) does not apply in the case of stock of specified 10% owned foreign corporations. §246(c)(5)(A)(ii).

432 §246(c)(5)(B). *See Varian Med. Sys., Inc. v. Commissioner*, 166 T.C. No. 8 (Apr. 8, 2026) (holding direct ownership of CFC stock during the specified period is required; thus, under §245A, Petitioner could not deduct §78 dividends attributable to CFCs owned indirectly through intermediate foreign corporations).

433 §245A(d); Reg. §1.245A(d)-1(a).

434 §904(b)(4).

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a dividend under §78, and received after December 31, 2017, would not be treated as a dividend for purposes of §245A.[435]

Following the Tax Court's 2024 decision, Varian Medical Systems and the IRS returned to the court to resolve a disagreement over the computation of Varian's deduction under §245A and the disallowed foreign tax credits under §245A(d)(1).[436] Because Varian is allowed a §245A deduction with respect to its §78 dividends attributable to directly owned CFCs, a corresponding portion of its foreign tax credit must be reduced.[437] In the 2024 decision, the Tax Court described the reduction as the amount of Varian's deemed paid foreign tax credit attributable to the foreign earnings reflected in its deductible §78 dividend. Expressed as a formula, the amount of the reduction is the "deemed paid foreign tax credit" multiplied by the ratio of the §78 gross-up over the sum of the "net §965 inclusion" and the §78 gross-up. In the subsequent dispute, the computation of the net §965 inclusion was at issue. The parties agreed the first step was to reduce a taxpayer's "accumulated post-1986 deferred foreign income" (§965(a) amount) by the aggregate foreign E&P deficit (§965(b) amount) with respect to its directly owned CFCs. Siding with the IRS, the court held that the §965(a) amount must be further reduced by the associated §965(c) deduction, which is taken into account to achieve the appropriate effective rate of the mandatory repatriation tax, applicable to Varian's last taxable year beginning before 2018.

For a detailed discussion of §245A, see 6130 T.M., *Participation Exemption Regime Under Section 245A* (Foreign Income Series), and for a discussion of §965, see 6280 T.M., *Transition Tax Under §965* (Foreign Income Series), at VIII.

e. *Consistency with Rules Under §246 and §1059*

The TCJA amended §246(a)(1) to deny the §245A DRD to corporate taxpayers receiving dividends from tax-exempt corporations and farmers' cooperative organizations.[438] In the case of extraordinary dividends received by a corporation, §1059(b)(2) was amended to include dividends received under §245A in the calculation of the reduction of a corporate shareholder's basis.[439]

f. *Extraordinary Dispositions*

The subpart F and §951A rules collectively tax foreign earnings from a controlled foreign corporation with §245A providing for an elimination of double taxation of dividends received by a U.S. shareholder.[440] There was a concern that there may be certain circumstances where earnings could circumvent these rules and still allow for a DRD under the literal reading of §245A. These circumstances arise when a CFC's fiscal year results in a mismatch between the effective date for §951A and the final measurement date under §965 or involve unanticipated interactions between §245A and the rules for allocating subpart F income and §951A income when there is a change in ownership of a CFC.

To eliminate the potential disparity, Reg. §1.245A-5 limits the deduction under §245A to 50% of an "extraordinary disposition amount."[441] The extraordinary disposition amount is the portion of a dividend received by a §245A shareholder from a specified foreign corporation (SFC) that is paid out of the §245A shareholder's "extraordinary disposition account."[442] This account contains the shareholder's pro rata share of the SFC's "extraordinary disposition E&P," reduced by the §245A shareholder's prior extraordinary disposition amounts, if any.[443]

The extraordinary disposition E&P is an amount equal to the earnings of an SFC arising from gain recognized by reason of one or more "extraordinary dispositions." This disposition must (i) be of specified property; (ii) occur during the SFC's disqualified period and when the SFC was a CFC; (iii) be outside of the ordinary course of the SFC's activities; and (iv) be to a related party.[444] A determination as to whether a disposition is undertaken outside of the ordinary course of an SFC's activities is made on the basis of facts and circumstances, taking into account whether the transaction is consistent with the SFC's past activities, including with respect to quantity and frequency.[445]

The rules go on to define a disposition as occurring outside of the ordinary course of an SFC's activities if the disposition is undertaken with a principal purpose of generating earnings and profits during the disqualified period or if the disposition is of intangible property, as defined in §367(d)(4).[446] The rules also provide a de minimis rule to exclude dispositions if the sum of the net gain recognized by an SFC with respect to specified property in all dispositions does not exceed the lesser of $50 million or 5% of the gross value of all of the SFC's property

[435] *See Varian Med. Sys., Inc. v. Commissioner*, 163 T.C. 76 (2024) (partial summary judgment granted in favor of a fiscal year taxpayer, allowing a deduction under §245A for amounts taxpayer properly treated as dividends under §78 for its 2018 tax year, but limiting foreign tax credits under §245A(d)(1) to the extent they are attributable to amounts treated as dividends under §78 and deducted under §245A; citing *Loper Bright Enters. v. Raimondo*, 603 U.S. 369 (2024), the court determined that the revised regulation could not change the effective date of the §78 amendments established by the unambiguous provisions of the TCJA). *See* Michael Rapoport, *Varian Ruling Opens Door for More Companies to Seek Deductions*, DTR (Oct. 2, 2024). *See also* CCA 202501008 (foreign disregarded entity wholly owned by a U.S. corporation filed a check-the-box election to be treated as a CFC for U.S. tax purposes while simultaneously electing a different tax year under §898(c)(2); Chief Counsel's Office concluded that §269 could apply and attributed the income of the CFC to the U.S. taxpayer directly). For a detailed discussion of CCA 202501008, see 750 T.M., *Corporate Overview*, at X.C.2.d.

[436] *See Varian Med. Sys., Inc. v. Commissioner*, 166 T.C. No. 8 (Apr. 8, 2026).

[437] §245A(d)(1).

[438] §246(a)(1).

[439] §1059(b)(2)(B).

[440] For taxable years beginning after 2025, §951A, as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70323, contains provisions on net CFC tested income (NCTI), formerly known as global intangible low-taxed income (GILTI) in taxable years beginning in 2018 through 2025.

[441] *See* T.D. 9909, 85 Fed. Reg. 53,068 (Aug. 27, 2020). *See* Reg. §1.245A-5(k) for the applicability date.

[442] Reg. §1.245A-5(b)(2), §1.245A-5(c)(1).

[443] Reg. §1.245A-5(c)(3)(i)(C).

[444] Reg. §1.245A-5(c)(3)(ii). For these purposes, a disposition by an SFC includes certain indirect dispositions by the SFC through a partnership or other pass-through entities (including through ownership structures involving tiered pass-through entities).

[445] Reg. §1.245A-5(c)(3)(ii)(B).

[446] Reg. §1.245A-5(c)(3)(ii)(C).

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held immediately before the beginning of its disqualified period.[447]

For a detailed discussion of §245A, see 6130 T.M., *Participation Exemption Regime Under Section 245A* (Foreign Income Series).

g. Hybrid Dividends

The §245A DRD is not available if a CFC distributes a "hybrid dividend" to a corporate U.S. shareholder.[448] A hybrid dividend for this purpose is an amount received from a CFC that would otherwise be eligible for the §245A DRD, and for which the CFC received a foreign tax benefit (i.e., a deduction or other tax benefit with respect to any income, war profits, or excess profits taxes imposed by any foreign country or U.S. possession).[449] The deduction or benefit must "relate to or result from" an amount paid, accrued or distributed with respect to each share of CFC stock determined at the close of the CFC's taxable year and is based on relevant foreign tax law.[450]

If a CFC with respect to which a domestic corporation is a U.S. shareholder receives a hybrid dividend from another CFC that has the same domestic corporation as a U.S. shareholder, then the hybrid dividend is treated as subpart F income of the recipient CFC for the taxable year in which the dividend was received.[451] The U.S. shareholder must include in its gross income an amount equal to its pro rata share of the subpart F income resulting from a hybrid dividend.[452] Neither the foreign tax credit nor a deduction is available for foreign income taxes paid with respect to both hybrid dividends paid to 10% U.S. corporate shareholders and hybrid dividends paid to 10% owned CFCs by subsidiary CFCs.[453]

To address the concern that the dividend and the hybrid deduction may be recognized in different taxable years, Treasury adopted final regulations under §245A that create a tracking system requiring the CFC shareholder to maintain a "hybrid deduction account" (HDA) for each share of CFC stock.[454] A CFC dividend is measured against the HDA and is generally treated as a hybrid dividend to the extent of the shareholder's balance in excess all of the hybrid deduction accounts held with respect to the CFC.[455] The measurement date is the close of the CFC tax year and is done by adding hybrid deductions and then subtracting hybrid dividends distributed during the year.[456]

Subsequently, Treasury adopted another set of final regulations that requires HDAs also to be reduced to the extent that the CFC's earnings and profits that have not been subject to foreign tax are "included in income" for U.S. tax purposes (i.e., taken into account in income and not offset by a related deduction or credit).[457] By making these reductions, the double non-taxation effects of certain hybrid arrangements are neutralized in a manner consistent with the tax results that would occur if such earnings or profits were distributed as a dividend for which the §245A DRD was not available.[458]

Note: The regulations have not been updated to reflect changes in the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21.

Under these regulations, the HDA is reduced at the end of each year by the following three categories of amounts that are included in the gross income of the domestic corporation for U.S. tax purposes: (1) the adjusted subpart F inclusion under §951(a)(1)(A), (2) the adjusted income inclusion under §951A, and (3) inclusions under §951(a)(1)(B) and §956 for earnings invested in U.S. property.[459]

For purposes of the third category, the reduction is made on a dollar-for-dollar basis. In other words, the amount of the reduction is equal to the amount included in income for earnings invested in U.S. property. The entirety of the amount is assumed to be included in income for U.S. tax purposes because there are generally no deductions or credits available to offset inclusions for earnings invested in U.S. property.[460]

For purposes of the first and second categories of reductions, the reduction is made based on an "adjusted" subpart F inclusion and an "adjusted" §951A income inclusion. These adjusted income inclusions are intended to measure the extent to which the domestic corporate shareholder's subpart F inclusion amount and §951A income inclusion amount are likely to be included in income for U.S. tax purposes. Thus, the amount of any subpart F inclusion or §951A income inclusion is adjusted prior to reducing the HDA to take into account any deemed foreign tax credit that would be allowable by approximating the amount of foreign tax effect of the foreign tax credit in determining the total reduction.[461] Additionally, any §250(a)(1)(B) deduction associated with a §951A income inclusion further reduces the amount of the reduction to the HDA.[462]

The regulations also provide rules if CFC stock is transferred regarding the carryover of the hybrid deduction account. A purchaser of CFC stock generally inherits the seller's hybrid deduction account in a taxable acquisition or tax free reorganization.[463] If a distribution of CFC stock qualifies as a tax-

[447] Reg. §1.245A-5(c)(3)(ii)(E). *See* CCA 202501008 (concluding, in alternative analysis, that certain intercompany sales by a foreign corporation indirectly and wholly owned by a U.S. shareholder were outside the corporation's ordinary course of business because a principal purpose of the sales was to generate earnings and profits during the disqualified period; the de minimis rule did not apply, and, thus, only 50% of a dividend paid by the corporation was subpart F income).

[448] §245A(e)(1).

[449] §245A(e)(4).

[450] Of note, where subnational income taxes of a country are covered taxes under an income tax treaty between the country and the United States, the tax law of the subnational authority should be treated as a tax law of a foreign country for purposes of §245A(e). *See* Reg. §1.245A(e)-1(f)(5).

[451] §245A(e)(2)(A).

[452] §245A(e)(2)(B). *See* §951(a)(2).

[453] §245A(e)(3).

[454] *See* T.D. 9896, 85 Fed. Reg. 19,802 (April 8, 2020). The final regulations are effective for distributions made after December 31, 2017, provided that such distributions occurred during tax years ending on or after December 20, 2018. Reg. §1.245A(e)-1(h).

[455] Reg. §1.245A(e)-1(d)(5).

[456] Reg. §1.245A(e)-1(d)(5).

[457] T.D. 9922, 85 Fed. Reg. 71,998 (Nov. 12, 2020).

[458] *See* preamble to REG-106013-19, 85 Fed. Reg. at 19,859.

[459] Reg. §1.245A(e)-1(d)(4)(i)(B). *See also* preamble to REG-106013-19, 85 Fed. Reg. at 19,859. For taxable years beginning after 2025, §951A, as amended by the OBBBA, Pub. L. No. 119-21, §70323, contains provisions on Net CFC Tested Income (NCTI), formerly known as Global Intangible Low-Taxed Income (GILTI) in taxable years beginning in 2018 through 2025.

[460] Reg. §1.245A(e)-1(d)(4)(i)(B)(3). *See also* preamble to REG-106013-19, 85 Fed. Reg. at 19,860.

[461] *See* Reg. §1.245A(e)-1(d)(4)(ii)(A), §1.245A(e)-1(d)(4)(ii)(B). *See also* Preamble to REG-106013-19, 85 Fed. Reg. at 19,860.

[462] *See* §1.245A(e)-1(d)(4)(ii)(B).

[463] Hybrid dividend accounts are eliminated if a §338(g) election is made in connection with an acquisition of stock. *See* Reg. §1.245A(e)-1(d)(4)(iii).

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free spinoff under §355, the balance of the hybrid deduction accounts are allocated between the distributing and controlled corporations in the same manner as E&P is allocated.[464] If there is a tax-free liquidation under §332 of a lower-tier CFC to an upper tier CFC, each hybrid deduction account is increased in the upper tier CFC by the balance of the hybrid deduction account in the lower tier CFC. For CFC transfers that occur during the year, the annual hybrid deductions that are calculated at the end of the year are allocated between the pre- and post-transfer periods on a pro rata basis to determine the hybrid deduction account balance for the portion of the year up to and including the transfer date.

The regulations also include anti-avoidance rules that allow the IRS to make adjustments if the principal purpose of a transaction was to avoid §245A(e). However, the regulations clarify that a CFC that eliminates hybrid deductions does not trigger the anti-avoidance rule.[465]

For further discussion about hybrid dividends and §245A, see 6130 T.M., *Participation Exemption Regime Under Section 245A* (Foreign Income Series), and 6280 T.M., *CFCs — Sections 959–965 and 1248* (Foreign Income Series), at IX.A.

h. PFIC Purges

If a U.S. shareholder elects to include in gross income its share of a PFIC's purging distribution under §1291(d)(2)(B), the amount is not treated as a dividend for purposes of the §245A DRD under §245A.[466]

i. Basis Reduction Rule

Effective for distributions made after December 31, 2017, the basis of a U.S. shareholder's stock in a "specified 10-percent owned foreign corporation" is reduced if a corporate U.S. shareholder receives a DRD under §245A and, in the same taxable year or a succeeding taxable year, the corporate U.S. shareholder must determine loss due to a disposition of the stock.[467] Section 961(d) provides that, solely for purposes of determining loss on any disposition of stock of such a foreign corporation, the basis of the domestic corporation in the stock is reduced (but not below zero) by the amount of a §245A DRD allowable with respect to the stock except to the extent the basis was reduced by the nontaxed portion of extraordinary dividends under §1059.[468]

7. Section 965

a. Current Rules — Transition Tax

The TCJA amended §965 to require repatriation of deferred foreign income in order for the United States to transition to a participation exemption system.[469] The mechanism for the transition tax, also known as a mandatory repatriation tax, is subpart F. Under §965(a), if a corporation is a deferred foreign income corporation (DFIC), it is required to include accumulated post-1986 deferred foreign income in its subpart F income with respect to its last taxable year beginning before January 1, 2018 (the inclusion year). As a result, U.S. shareholders are taxed on their pro rata shares of such income, and may deduct certain amounts under §965(c) to achieve special tax rates (15.5% for cash, and 8% for illiquid assets).[470] The effective tax rates applicable to such income inclusions are adjusted by way of a participation deduction set out in §965(c). The amount of the participation deduction is based upon the residual of the corporation's "aggregate foreign cash position" which provides for an effective rate of 15.5%, with the remainder taxed at an equivalent of 8%. For calendar year filers with a 35% income tax rate in effect for 2017, the participation exemption deductions are 55.7% of earnings and profits related to the aggregate cash position and 77.1% for accumulated earnings and profits related to the non-cash position.[471]

A U.S. shareholder of a DFIC may elect not to take into account the inclusion amount for determining the shareholder's NOL for the tax year or the amount of taxable income for the tax year and file an irrevocable election not to offset a §965 tax liability with net operating loss carryforwards.[472]

A U.S. corporate shareholder may elect to pay the net tax liability in eight annual back loaded installments under §965(h).[473] The election must be made by the due date of the tax return for the transition year. The first installment is due on the due date of the tax return for the transition year determined without regard to extensions. S corporation shareholders may elect to defer until a "trigger" event occurs.[474] Howev-

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[464] Reg. §1.245A(e)-1(d)(4)(iii)(B)(4).

[465] Reg. §1.245A(e)-1(e).

[466] §245A(f).

[467] §961(d).

[468] The application of §1059 may create a circularity issue as the basis will be reduced and create additional §1248 amounts and thus require the re-application of §1059.

[469] §965. *See* Reg. §1.965-1 through §1.965-9, T.D. 9846, 84 Fed. Reg. 1838 (Feb. 5, 2019), *corrected in* 84 Fed. Reg. 14,260 (Apr. 10, 2019), generally applicable beginning the last tax year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, beginning the tax year which or with which such tax year of the foreign corporation ends. The final regulations retained the basic approach and structure, with certain revisions, of the proposed regulations under REG-104226-18, 83 Fed. Reg. 39,514 (Aug. 9, 2018). The proposed regulations included, with modifications, certain rules provided in Notice 2018-7, Notice 2018-13, and Notice 2018-26.

[470] §951(a), §965(f).

[471] 55.7% is 1-(15.5%/35%), and 77.1 % is 1-(8%/35%).

[472] §965(n). Taxpayers may wish to make this election and effectively chose to offset the liability with foreign tax credits instead of net operating losses. The Coronavirus Aid, Relief, and Economic Security (CARES) Act provides that if an NOL arising in tax years 2018, 2019, or 2020 is carried back to a tax year in which there is inclusion of deferred foreign income under §965(a), the taxpayer will be deemed to have made an election under §965(n), unless the taxpayer makes an election under §172(b)(3). Pub. L. No. 116-136, §2303(b)(1).

[473] The installment percentages under §965(h) are as follows: 8 percent of the net tax liability for each of the first 5 installments; 5 percent of the net tax liability for the 6th installment; 20 percent of the net tax liability for the 7th installment; and 25 percent of the net tax liability for the 8th installment. Note that individuals who had already filed a 2017 return without electing to pay the transition tax in eight annual installments could still make the election by filing a 2017 Form 1040-X with the IRS by October 15, 2018. For individual taxpayers who missed the April 18, 2018, deadline for making the first of the eight annual installment payments, the IRS would waive the late-payment penalty if the installment was paid in full by April 15, 2019. This relief was available only if the individual's total transition tax liability was less than $1 million. Moreover, in some instances, the IRS would waive the estimated tax penalty for taxpayers subject to the transition tax who improperly attempted to apply a 2017 calculated overpayment to their 2018 estimated tax, as long as they made all required estimated tax payments by June 15, 2018. See IRS News Release IR-2018-131. For additional IRS guidance, see *General Section 965 Questions and Answers (Including Transfer and Consent Agreements).*

[474] §965(i). For IRS guidance, see *General Section 965 Questions and Answers (Including Transfer and Consent Agreements).*

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er, this election is not available for partnerships. The statute of limitations for the assessment of the net tax liability under §965 does not expire before the date that is 6 years after the date the return for the taxable year was filed.[475]

Any person that is required to include amounts in income under §965 in its tax year beginning in 2017 or its tax year beginning in 2018, whether because the person is a U.S. shareholder of a DFIC or because it is a direct or indirect partner in a domestic partnership, a shareholder in an S corporation, or a beneficiary in another pass-through entity, and such pass-through entity is a U.S. shareholder in a DFIC, must complete and attach Form 965 to its income tax return. In addition, any person that would be required to include amounts in income under §965 but for an aggregate foreign E&P deficit allocated in accordance with §965(b) must complete and attach Form 965 to its income tax return. Any person that elects to pay its net tax liability over eight years is required to check the appropriate box in Part III of Form 965 and attach a statement to its return as provided in Reg. §1.965-7(b)(2)(iii).

The following discussion provides a summary of the rules of the §965 transition tax. For a more detailed discussion of the §965 transition tax, see 6280 T.M., *CFCs — Sections 959–965 and 1248*, at VIII.

(1) Deferred Foreign Income Corporations and Specified Foreign Corporations

A DFIC is, with respect to any U.S. shareholder, any SFC of such U.S. shareholder that, as of the relevant measuring date, has accumulated post-1986 deferred foreign income greater than zero.[476] An SFC is any controlled foreign corporation (CFC), and any foreign corporation that has one or more domestic corporations as a U.S. shareholder.[477] If a foreign corporation with one or more U.S. corporate shareholders is an SFC, it is treated as a CFC solely for purposes of applying the transition tax and determining the U.S. shareholders' pro rata share and basis adjustments.[478]

(2) Inclusion Year

As stated above, the inclusion year for the repatriation tax is the DFIC's last taxable year beginning before January 1, 2018.[479] However, in Rev. Proc. 2018-17, the IRS explained that an SFC could avoid the purposes of §965 if it changes its taxable year. This could result in a deferral of a U.S. shareholder's inclusion with respect to a DFIC by as much as 11 months, or a reduction of the post-1986 earnings and profits (E&P), discussed below, of a DFIC and a reduction of the tax liability of a U.S. shareholder of a DFIC. To address these problems, Rev. Proc. 2018-17 modifies two revenue procedures governing changes in annual accounting periods: Rev. Proc. 2002-39 and Rev. Proc. 2006-45. The modifications provide the circumstances under which an SFC cannot change its annual accounting period and use a new taxable year. The final regulations provide that any accounting method change made for an SFC's tax year that ends in 2017 or 2018 is disregarded for purposes of the application of §965 (regardless of whether the accounting method change is properly made) if the accounting method change would change the amount of a U.S. shareholder's §965(a) inclusion amount with respect to the SFC or a U.S. shareholder's aggregate foreign cash position, or change the amount of the SFC's foreign income taxes deemed paid by a U.S. shareholder under §960 as a result of a §965(a) inclusion other than by reason of an increase in a §965(a) inclusion amount with respect to the SFC.[480]

(3) Accumulated Post-1986 Deferred Foreign Income

The subpart F income of a DFIC in the inclusion year is increased by the greater of the amount of accumulated post-1986 deferred foreign income determined as of November 2, 2017, or December 31, 2017 (the measurement date).[481] Accumulated post-1986 deferred foreign income means the post-1986 E&P[482] calculated under §964(a) and §986, accumulated in taxable years beginning after December 31, 1986, and determined as of the relevant measurement date, only taking into account periods when the corporation was an SFC, and without diminution by reason of dividends distributed during taxable years beginning before January 1, 2018 (other than dividends distributed to another SFC).[483] Earnings that are effectively connected with conduct of a U.S. trade or business and subject to tax under chapter 1 of the Code, and earnings that, in the case of a CFC, would be excluded from gross income of a U.S. shareholder under §959 are excluded from accumulated post-1986 deferred foreign income.[484]

(a) Computation Issues

To address issues of double counting and noncounting in determining the amount of accumulated post-1986 deferred foreign income, Reg. §1.965-4(f)(1) provides a general rule under which a specified payment made by an SFC to another SFC is disregarded for purposes of determining the post-1986 E&P of each SFC as of the E&P measurement date on December 31, 2017. For this purpose, a specified payment is an amount paid by the payor SFC if (i) the payor SFC and the payee SFC are related within the meaning of §954(d)(3), (ii) the payment occurs after November 2, 2017, and on or before December 31, 2017, and (iii) but for the application of the general rule, the payment would reduce the post-1986 E&P of the payor SFC as of the E&P measurement date of December 31, 2017. Under an exception, Reg. §1.965-4(f)(3) provides that a §958(a) U.S. shareholder may choose not to apply the general rule so long as that §958(a) shareholder and all related §958(a) shareholders do not apply the rule with respect to any of their SFCs.[485] The final regulations also generally provide that an SFC's post-1986 E&P generally is determined without being reduced by dividends distributed during the last tax year of the SFC that begins be-

[475] §965(k).

[476] *See* §965(d)(1); Reg. §1.965-1(f)(17). All instances of the terms "specified foreign corporation" and "SFC" in this discussion refer to SFCs as defined in §965(e) and Reg. §1.965-1(f)(17). *Cf.* §898(b).

[477] §965(e)(1); Reg. §1.965-1(f)(45). Passive foreign investment companies (PFICs) that are not CFCs are excluded from the definition of SFCs. §965(e)(3); Reg. §1.965-1(f)(45)(iii).

[478] §965(e)(2); Reg. §1.965-1(d).

[479] §965(a); Reg. §1.965-1(f)(26).

[480] Reg. §1.965-4(c)(1).

[481] §965(a); Reg. §1.965-1(b), §1.965-1(f)(36), §1.965-1(f)(23).

[482] §965(d)(3); Reg. §1.965-1(f)(29).

[483] §965(d)(2); Reg. §1.965-1(f)(7).

[484] §965(d)(2)(A), §965(d)(2)(B); Reg. §1.965-1(f)(7)(i).

[485] Reg. §1.965-4(f).

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fore January 1, 2018; however, an SFC's post-1986 E&P may be reduced by a dividend distributed to another related SFC to the extent that the dividend increases the post-1986 E&P of the SFC receiving the dividend.[486] The final regulations provide the following example illustrating the issues of double counting and dividend reduction:[487]

> *Example:* USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 have calendar year taxable years. On November 2, 2017, each of CFC1 and CFC2 has post-1986 earnings and profits of 100u. Neither CFC1 nor CFC2 has previously taxed income or effectively connected income for any taxable year. Therefore, for both CFC1 and CFC2, accumulated post-1986 deferred foreign income is equal to post-1986 earnings and profits. On November 3, 2017, CFC2 makes a 10u dividend distribution to CFC1. The payment does not constitute subpart F income. CFC1 and CFC2 have no other items of income or deduction. The dividend distribution is a specified payment because (i) CFC2 and CFC1 are related within the meaning of §954(d)(3), (ii) the payment occurs after November 2, 2017, and on or before December 31, 2017, and (iii) but for the application of the general rule of Reg. §1.965-4(f)(1), the payment would reduce the post-1986 E&P of CFC2 as of the E&P measurement date of December 31, 2017. Under Reg. §1.965-4(f)(1), the dividend distribution is disregarded and, as a result, CFC1 and CFC2 each have post-1986 E&P of 100u as of the E&P measurement date on December 31, 2017.

The final regulations also address two other calculation issues involving non-U.S. shareholders and coordination with §959. First, if a CFC has shareholders that are non-U.S. shareholders on a measurement date, the accumulated post-1986 deferred foreign income of the CFC on that measurement date is reduced by amounts that would be excluded as previously taxed income under §959 if those shareholders were U.S. shareholders.[488]

Second, the final regulations provide the following rules relating to adjustments to the E&P of an SFC for purposes of applying §959, as well as §902, §960, and §965:[489]

1. The subpart F income of the SFC is determined (without regard to §965(a) but taking into account any relevant distributions), and the E&P of the SFC is increased to the extent of the §951(a)(1)(A) inclusion (without regard to §965(a)).

2. The treatment of a distribution from the SFC to another SFC made before January 1, 2018, and, in the case of a taxable year of an SFC before its last taxable year that begins before January 1, 2018, any other distribution from the SFC made before the relevant E&P measurement date, is determined under §959.

3. The SFC's post-1986 E&P, accumulated post-1986 deferred foreign income, §965(a) earnings amount, and §965(a) inclusion amount are determined taking into account the rules of Reg. §1.965-4, and the SFC's E&P is adjusted as provided in Reg. §1.965-2(c) and §1.965-2(d).

4. The treatment of all distributions from the SFC other than those described in step 2 is determined under §959, and the treatment of all distributions from the SFC described in step 2 and disregarded under Reg. §1.965-4 is redetermined (if necessary).

5. An amount is determined under §956 with respect to the SFC and the U.S. shareholder, the SFC's §959(c)(2) E&P is reclassified as §959(c)(1) E&P to the extent it would otherwise be a §951(a)(1)(B) inclusion amount of the U.S. shareholder, and the §959(c)(1) E&P is further increased to the extent of the §951(a)(1)(B) inclusion amount of the U.S. shareholder.

(b) Alternative Method

The IRS has recognized that it may be impractical for taxpayers to determine the post-1986 E&P of an SFC as of a measurement date that does not fall on the last day of the month, such as the E&P measurement date of November 2, 2017.[490] Therefore, the final regulations permit taxpayers to elect an alternative method for calculating post-1986 E&P by using a "notional measurement date." The notional measurement date depends on whether or not an SFC has a 52–53-week tax year. If an SFC uses a 52–53-week tax year, the notional measurement date is the fiscal month ending date that is closest to the E&P measurement date. Otherwise, the notional measurement date is October 31, 2017.[491] The IRS has issued guidance on how to make this election.[492]

(4) Treatment of Income to U.S. Shareholders

Section 965(f) provides that a U.S. shareholder's pro rata share of an amount with respect to an SFC is determined under rules similar to §951(a)(2) by treating the amount as subpart F income and by treating the SFC as a CFC.[493] A U.S. shareholder with respect to a DFIC includes in its income its pro rata share of the DFIC's subpart F income, and if the shareholder is a U.S. shareholder with respect to other SFCs with E&P deficits, the U.S. shareholder may reduce its income inclusion under §951(a)(1) by allocating aggregate foreign E&P deficits to the DFIC.[494]

Section 965 provides for special rates on income included by U.S. shareholders of a DFIC in the inclusion year: a 15.5% rate applies to cash and cash equivalents, and an 8% rate applies to illiquid assets. Mechanically, the rates are achieved

486 Reg. §1.965-1(f)(29)(i).

487 Reg. §1.965-4(f)(4)(ii).

488 §965(d)(2) (flush language); Reg. §1.965-1(f)(7)(i)(B), §1.965-1(f)(7)(i)(C).

489 Reg. §1.965-2(b), T.D. 9846, 84 Fed. Reg. 1838 (Feb. 5, 2019), *corrected in* 84 Fed. Reg. 14,260 (Apr. 10, 2019). *See also* Notice 2019-1, in which the IRS announced that it intends to issue regulations addressing certain issues with respect to previously taxed earnings and profits of foreign corporations excluded from gross income of U.S. shareholders under §959.

490 *See* Notice 2018-13.

491 Reg. §1.965-7(f).

492 Reg. §1.965-7(f)(5).

493 §965(f)(1); Reg. §1.965-1(f)(30).

494 §965(a), §965(b)(1); Reg. §1.965-1(b).

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through deductions under §965(c) and the use of "rate equivalent percentages." This mechanism is intended to ensure that the tax rates imposed on the deferred foreign income is similar for all U.S. shareholders, regardless of the §965 inclusion year, which may occur in taxable years in which the general corporate rate is 35%, 21%, or a blended rate under §15.[495]

The deduction amount is equal to the sum of:

- the U.S. shareholder's 8% rate equivalent percentage of the excess of the amount included as gross income over the amount of the U.S. shareholder's aggregate foreign cash position; and
- the U.S. shareholder's 15.5% rate equivalent percentage of the amount of the aggregate foreign cash position (to the extent it does not exceed the amount included in gross income).[496]

The 8% and 15.5% rate equivalent percentages apply a formula to determine the percentage that would need to be applied to the deferred foreign income as the only allowable deduction in order to arrive at a tax rate of 8% or 15.5%, as the case may be, assuming the highest rate of tax specified in §11 for the taxable year. Accordingly, the 8% rate equivalent percentage is the percentage that results in the amount to which such percentage applies being subject to an 8% rate of tax determined by only taking into account a deduction equal to such percentage of such amount and the highest tax rate under §11 for that taxable year.[497] Similarly, the 15.5% rate equivalent percentage is the percentage that results in the amount to which such percentage applies being subject to an 15.5% rate of tax determined by only taking into account a deduction equal to such percentage of such amount and the highest tax rate under §11 for that taxable year.[498] For a taxable year of a U.S. shareholder to which §15 applies, the highest tax rates before and after the effective date of the change in rates must be taken into account proportionally with respect to the portions of the taxable year before and after the effective date of the change in rates.[499]

(a) Aggregate Foreign Cash Position

A U.S. shareholder's aggregate foreign cash position is generally the aggregate of its pro rata share of the cash and cash equivalents of each of the U.S. shareholder's SFCs. The aggregate foreign cash position determination is made as of the close of the inclusion year (i.e., the last taxable year of the SFC beginning before January 1, 2018), unless the November 2, 2017, measurement date (together with the preceding taxable year) would yield a larger amount.[500]

For purposes of determining the deduction amount under §965(c)(1), the term "aggregate foreign cash position" is defined as the greater of:

(1) the aggregate of a U.S. shareholder's pro rata share of the cash position of each SFC of the U.S. shareholder determined as of the close of the inclusion year (i.e., the last taxable year of the SFC beginning before January 1, 2018); or

(2) one half of the sum of: the amount described in (1) determined as of the close of the last taxable year of each such SFC ending before November 2, 2017; and the amount described in (1) determined as of the close of the taxable year of each SFC that precedes the taxable year ending before November 2, 2017.[501]

An SFC's cash position is defined as the sum of:

- cash held by the SFC;
- "net accounts receivable" of the SFC;[502]
- the fair market value of personal property held by the SFC that is actively traded and for which there is an established financial market;
- the fair market value of commercial paper, certificates of deposit, and federal, municipal, and foreign government securities held by the SFC;
- the fair market value of any foreign currency held by the SFC;
- the fair market value of obligations with terms of less than one year that are held by the SFC;[503] and
- any asset that the Secretary identifies as being economically equivalent to any asset above.[504]

To prevent double counting in the aggregate foreign cash position calculation, §965(c)(3)(D) provides that net accounts receivable, actively traded property, and obligations having terms of less than one year need not be taken into account by a U.S. shareholder if the U.S. shareholder demonstrates to the satisfaction of the Secretary that the amount is taken into account by the U.S. shareholder with respect to another SFC.[505] For this purpose, a noncorporate entity will be treated as an SFC if any interest in the noncorporate entity is held by an SFC

[495] *See* H.R. Rep. No. 115-466, at 620 (2017) (Conf. Rep.). *See also* Lowell D. Yoder, David G. Noren & Elizabeth R. Chao, *Tax Reform: Taxation of Income of Controlled Foreign Corporations*, 14 DTR S-15 (Jan. 22, 2018).

[496] §965(c)(1)(A), §965(c)(1)(B); Reg. §1.965-1(f)(1), §1.965-1(f)(3), §1.965-1(f)(42).

[497] §965(c)(2)(A); Reg. §1.965-1(f)(2). The American Institute of Certified Public Accountants (AICPA) recommended a technical correction to §965(c)(2)(A) that would clarify that the gross amount included under §965(c)(1) would not be subject to the alternative minimum tax and that the deduction would not fall within the definition of miscellaneous itemized deductions under §67. *See* Letter from Annette Nellen, Chair, AICPA Tax Exec. Comm., to the Honorable Orrin G. Hatch, Chairman, U.S. Senate Comm. on Fin. et al. (Feb. 22, 2018).

[498] §965(c)(2)(B); Reg. §1.965-1(f)(4).

[499] §965(c)(2)(A); Reg. §1.965-1(f)(2).

[500] *See also* Reg. §1.965-1(f)(8)(i), §1.965-1(f)(24), §1.965-1(f)(25), §1.965-1(f)(31). *See generally* §965(c)(3)(A).

[501] §965(c)(3)(A). *See also* Reg. §1.965-1(f)(8)(i).

[502] Net accounts receivable are defined as the excess of an SFC's accounts receivable over the SFC's accounts payable determined under §461. §965(c)(3)(C); Reg. §1.965-1(f)(27). Accounts receivable for this purpose refers to receivables described in §1221(a)(4), and accounts payable refers to payables arising from the purchase of property in §1221(a)(1) or §1221(a)(8) or the receipt of services from vendors or suppliers. Reg. §1.965-1(f)(5), §1.965-1(f)(6). Receivables treated as accounts receivable under §965(c)(3)(C)(i) are not treated as short-term obligations. Reg. §1.965-1(f)(43).

[503] Loans that must be repaid on the demand of the lender or repaid within one year of a demand will be treated as short-term obligations for purposes of §965(c)(3)(B). *See also* Reg. §1.965-1(f)(43). Section 965(c)(3)(B) refers to obligations with a term of less than one year but does not expressly refer to "short-term obligations." However, the final regulations refer to "short-term obligations" and define them to include any obligation with a term upon issuance that is less than one year. Reg. §1.965-1(f)(13)(i)(D), §1.965-1(f)(43).

[504] §965(c)(3)(B); Reg. §1.965-1(f)(16)(i).

[505] §965(c)(3)(D); Reg. §1.965-3(b)(2).

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and the noncorporate entity would be an SFC if it were a foreign corporation. In such case, the U.S. shareholder's pro rata share of the cash position of the noncorporate entity is reduced by the pro rata share of the amount attributable to deemed stock of the noncorporate entity not owned by an SFC.[506]

(b) Reductions for U.S. Shareholders of SFCs with Deficits in Earnings and Profits

If a U.S. shareholder is a U.S. shareholder with respect to one DFIC and at least one E&P deficit corporation, it may allocate its aggregate foreign E&P deficit to the DFIC.[507] An E&P deficit corporation is an SFC with a deficit in post-1986 E&P as of November 2, 2017.[508] However, because a corporation that is a DFIC may also be classified as an E&P deficit corporation, the determination of whether a corporation is a DFIC is made first.[509] Thus, if a corporation is a DFIC, it is not also classified as an E&P deficit corporation despite having a deficit in post-1986 E&P. If an SFC is not a DFIC, then the U.S. shareholder must determine whether the corporation is an E&P deficit corporation.[510] Notwithstanding this ordering rule, an SFC may be classified as neither a DFIC nor an E&P deficit corporation, even if it has post-1986 E&P greater than zero or a deficit in accumulated post-1986 deferred foreign income.[511]

The aggregate foreign E&P deficit is the lesser of: (1) the aggregate of the shareholder's pro rata shares of the specified E&P deficits of all E&P deficit foreign corporations of the shareholder; or (2) the aggregate of the U.S. shareholder's pro rata share of the accumulated post-1986 deferred foreign income of all DFICs of the shareholder.[512] If the amount in (2) is less than the amount in (1), then the U.S. shareholder must designate the amount of the specified E&P deficit that is to be taken into account for each of its E&P deficit corporations and, in the case of an E&P deficit corporation that has a qualified deficit (as defined in §952), the portion (if any) of the deficit taken into account under (1) that is attributable to a qualified deficit.[513]

The aggregate foreign E&P deficit must be allocated among the DFICs of a U.S. shareholder in an amount that bears the same proportion to such aggregate as: (1) the U.S. shareholder's pro rata share of accumulated post-1986 deferred foreign income of the DFIC bears to (2) the aggregate of the U.S. shareholder's pro rata share of the accumulated post-1986 deferred foreign income of all of the DFICs of the U.S. shareholder.[514]

For purposes of applying §959 for taxable years beginning with the inclusion year, an amount equal to a U.S. shareholder's allocated reduction under §965(b)(1) is treated as an amount that was included in the gross income of the U.S. shareholder under §951(a).[515] In addition, for taxable years beginning with the inclusion year, a U.S. shareholder's pro rata share of the E&P of any E&P deficit corporation is increased by the amount of the specified E&P deficit of the corporation taken into account under §965(b)(1), and for purposes of §952, the increase is attributable to the same activity to which the deficit so taken into account was attributable.[516]

(5) Partial Disallowance of Foreign Tax Credit

Section 965(g) provides for coordination with the limitations on foreign tax credits because, in general, neither a foreign tax credit nor a deduction is available for a portion of foreign income taxes deemed paid or accrued with respect to the increased subpart F income attributable to the inclusion of deferred foreign income.[517] Under this rule, also called the coordination rule or "haircut," the foreign taxes treated as paid or accrued by a domestic corporation as a result of the income inclusion are limited to those taxes in proportion to the taxable portion of the §965 inclusion.[518]

Accordingly, a foreign tax credit is disallowed under §901 for the "applicable percentage" of any taxes paid or accrued or treated as such with respect to any amount that is deductible under §965.[519]

The applicable percentage is the amount (expressed as a percentage) equal to the sum of:

- 0.771 multiplied by the ratio of the excess to which §965(c)(1)(A) applies divided by the sum of such excess plus the amount to which §965(c)(1)(B) applies; and
- 0.557 multiplied by the ratio of the amount to which §965(c)(1)(B) applies divided by the sum of the excess to which §965(c)(1)(A) and the amount to which §965(c)(1)(B) applies.[520]

[506] §965(c)(3)(E); Reg. §1.965-3(b)(3).

[507] §965(b)(1); Reg. §1.965-1(b)(2).

[508] §965(b)(3)(B); Reg. §1.965-1(f)(22).

[509] Reg. §1.965-1(f)(17)(ii).

[510] Reg. §1.965-1(f)(22).

[511] Reg. §1.965-1(g)(5).

[512] §965(b)(3)(A)(i); Reg. §1.965-1(f)(9). The specified E&P deficit of an E&P deficit corporation is the corporation's deficit in post-1986 E&P. §965(b)(3)(C); Reg. §1.965-1(f)(44).

[513] §965(b)(3)(A)(ii); Reg. §1.965-2(d)(2)(ii)(B).

[514] §965(b)(2); Reg. §1.965-1(f)(11).

[515] §965(b)(4)(A).

[516] §965(b)(4)(B); Reg. §1.965-2(d)(2)(i).

[517] Deductions are disallowed under §965(g)(3). *See* H.R. Rep. No. 115-466, at 620 (2017) (Conf. Rep.).

[518] *See* H.R. Rep. No. 115-466, at 620 (2017) (Conf. Rep.).

[519] §965(g)(1); Reg. §1.965-5(b), §1.965-5(c). Reg. §1.965-5(b) also provides that the foreign tax credit is disallowed for the applicable percentage of any foreign income taxes attributable to a distribution of previously taxed earnings and profits under §965(a) or §965(b). The IRS became aware that taxpayers might engage in transactions intended to avoid the application of this rule. For example, U.S. shareholders of foreign corporations may incur foreign income taxes on distributions recognized for foreign tax purposes but not U.S. tax purposes (e.g., consent dividends) and then when §965(a) or §965(b) previously taxed earnings and profits are distributed for U.S. tax purposes, no foreign income taxes are imposed. Such taxpayers might potentially take the position that the §965(g) foreign tax credit disallowance would not apply in this situation because the foreign income taxes on the foreign distributions are not associated with the distributions of §965(a) or §965(b) previously taxed earnings and profits. Thus, in 2020, Treasury adopted final regulations that eliminate this potential interpretation by clarifying that the principles of Reg. §1.904-6 apply in determining the extent to which foreign income taxes are attributable to distributions of §965(a) or §965(b) previously taxed earnings and profits. Reg. §1.965-5(b)(2), added by T.D. 9922, 85 Fed. Reg. 71,998 (Nov. 12, 2020), adopting REG-105495-19, 84 Fed. Reg. 69,124 (Dec. 17, 2019). Reg. §1.965-5(b)(2) applies to tax years of foreign corporations ending on or after December 16, 2019, and to the tax years of U.S. shareholders in which or with which the foreign corporation's tax year ends. Reg. §1.965-9(c).

[520] §965(g)(2); Reg. §1.965-5(d). The haircut disallows the portion of foreign tax credits associated with the earnings that, at the 35% pre-TCJA corporate tax rate, would be deducted in order to reach the 15.5% and 8% transition tax rates (55.7% is 1-(15.5%/35%), and 77.1 % is 1-(8%/35%)). *See* Lowell D. Yoder, David G. Noren & Elizabeth R. Chao, *Tax Reform: Taxation of Income of Controlled Foreign Corporations*, 14 Daily Tax Rep. S-15 (Jan. 22, 2018).

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The §78 gross up amount applies only to the amount of taxes having the same proportion to the amount of such taxes as: (1) the excess of (i) the amounts includible in gross income of the domestic corporation by reason of §965, over (ii) the deduction allowable under §965(c) with respect to such amounts, bears to (2) such amounts.[521]

For a detailed discussion of the disallowance of the foreign tax credit under §965(g), see 6280 T.M., *CFCs — Sections 959–965 and 1248* (Foreign Income Series), at VIII.E.

(6) Illustration

Example: Assume a domestic corporation has owned 100% of the outstanding stock of three foreign corporations since 1986 and is taxed at a corporate income tax rate of 35%. Also assume that the domestic corporation and all the foreign subsidiaries have taxable year-ends of December 31, 2017, and that there were no cash distributions in 2017 and no previously taxed income.

SFC1 had an accumulated E&P balance of $0 on November 2, 2017, and an accumulated E&P balance of $0 on December 31, 2017. SFC2 had an accumulated E&P balance of $100 on November 2, 2017, and an accumulated E&P balance of $200 on December 31, 2017. SFC3 had an accumulated E&P balance of $400 on November 2, 2017, and an accumulated E&P balance of $300 on December 31, 2017. Under §965, the domestic corporation will have a $600 inclusion (SFC1 – $0, SFC2 – $200 & SFC3 – $400).

The average aggregate cash position of SFC 1 for tax years ending December 31, 2015, and December 31, 2016, was $50, and the cash position, as of December 31, 2017, was $0. The average aggregate cash position of SFC 2 for tax years ending December 31, 2015, and December 31, 2016, was $100, and the cash position, as of December 31, 2017, was $200. The average aggregate cash position of SFC 3 for tax years ending December 31, 2015, and December 31, 2016, was $150, and the cash position, as of December 31, 2017, was $200. Thus, the total aggregate cash position was $450 (SFC1 – $50, SFC2 – $200 & SFC3 – $200), and the remaining non-cash position was $150 ($600 less $450).

To determine the participation exemption, the inclusion is split between the cash and non-cash portion. The cash position is 55.7% of $450, which is $251. The non-cash portion is 77.1% of $150, which is $116. Thus, the total §965 inclusion is $233 ($600 less $251 less $116). The federal tax due (assuming no NOLs or foreign tax credits to offset the inclusion or the tax liability) is approximately $82 ($233 multiplied by the 35% rate in effect in 2017). The corporation can elect to pay the tax over 8 annual installments.

The domestic corporation can offset the $233 income inclusion if it has an NOL carryforward that has no restrictions. Alternatively, the domestic corporation can make an election to forgo the use of the NOL carryforward and offset the $233 inclusion with foreign tax credits based on the tax pools from the specified foreign corporations. It will have to include the amount of the tax pools as a §78 gross up if the foreign tax credits are used to offset the tax due from the inclusion and the foreign tax credits will need to be reduced to reflect the participation exemption percentage. The decision to utilize the foreign tax credits and forgo the use of the NOL is based on the value of the NOL to offset future taxable income at the rate in effect (21%) and the removal of the corporate alternative minimum tax[522] (allows a 90% deduction for NOL carryforwards) for tax years beginning after December 31, 2017.

b. Temporary 85% DRD for CFC Dividends Under Former §965

The American Jobs Creation Act of 2004[523] added former §965 to the Code, providing a one-year 85% DRD for cash dividends received by corporate U.S. shareholders from CFCs. The DRD was available only for extraordinary dividends up to a ceiling amount and to the extent the qualifying dividends were reinvested in the United States.

The 85% DRD was temporary; it applied only to one taxable year. A corporate taxpayer was permitted to apply former §965 to cash dividends received from CFCs during either of the following two years:

- the taxpayer's last taxable year that began before October 22, 2004; or
- the taxpayer's first taxable year that began during the one-year period beginning on such date.[524]

E. Debt-Financed Portfolio Stock Limitation

1. General

This narrowly focused limitation seeks to thwart taxpayers from obtaining a double benefit by claiming the DRD with respect to dividend income already sheltered by interest deductions. The limitation addresses certain situations in which a corporate shareholder invests in dividend-paying stocks with borrowed funds "directly attributable" to the investment. To combat the perceived abuse, §246A reduces the percentage of the otherwise allowable DRD (50% or 65%).[525] This limitation does not apply to the 100% DRD.[526] The allowable DRD, after reduction, equals 100% minus the "average indebtedness percentage."

Example: Corporation Z invests in 25% of the stock of corporation Y for $250,000, financing the investment in part by borrowing 40% of the purchase price ($100,000). While the loan is still outstanding, Y pays a dividend to

[521] §965(g)(4); Reg. §1.965-5(c)(3). *See* H.R. Rep. No. 115-466, at 620 (2017) (Conf. Rep.) (explaining that the gross up amount equals the total foreign income taxes multiplied by the fraction, the numerator being the taxable portion of the increased subpart F income under §965 and the denominator being the total increase in subpart F income under §965).

[522] For tax years beginning after December 31, 2017, the corporate tax rate was reduced to a flat 21% and the corporate alternative minimum tax was repealed, §11(b), §55(a), as amended by the TCJA, Pub. L. No. 115-97, §13001(a), §12002.

[523] Pub. L. No. 108-357, §422.

[524] *See* Notice 2005-10, §9 (transition rules). *See also* Notice 2005-64, §11 (additional transition rules), *obsoleted by* Notice 2025-22.

[525] §246A(a)(1). For taxable years beginning before January 1, 2018, the applicable DRD percentages were 70% and 80%. For taxable years beginning after December 31, 2017, the TCJA reduced the 70% DRD to 50% and reduced the 80% DRD to 65%. *See* §243.

[526] §246A(b).

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Z of $5,000. Ordinarily, Z would be entitled to the 65% DRD, or $3,250 (65% of $5,000). However, because the investment was 40% leveraged, §246A reduces the 65% DRD to 39%, i.e., 65% × (100% – 40%), yielding a DRD of $1,950 (39% of $5,000).

2. Definitions

The target of §246A is "debt-financed portfolio stock," defined as any portfolio stock with respect to which there is portfolio indebtedness at any time during the "base period."[527]

The purchasing corporation does not have to incur the debt for the §246A restriction to apply. In *H Enters. Int'l, Inc. v. Commissioner*,[528] the Tax Court denied summary judgment and held that §246A may apply when one member of an affiliated group is the borrower and another member is the purchaser of portfolio stock. The court stated that whether the investment in portfolio stock by one member is directly attributable to borrowings by the other member is a question of fact to be determined at trial. In a subsequent case, *H Enters. Int'l, Inc. v. Commissioner*,[529] the Tax Court found that a subsidiary had incurred debt to make a distribution to its parent and that these distributed funds were used by the parent to purchase and carry tax-exempt obligations and portfolio stock. The court denied the interest deduction (under §265(a)(2)) and the DRD (under §246A) claimed by the parent on its consolidated return.

a. Portfolio Stock

"Portfolio stock" means any stock, other than §1504(a)(4) stock.[530] However, the target of the provision is the portfolio investor, i.e., a shareholder not in control of the distributing corporation. Accordingly, the following are excluded from the definition of "portfolio stock:" stock representing 50% or more of the vote and value of the distributing corporation,[531] and stock representing 20% or more of the distributing corporation if it is closely held (i.e., if five or fewer corporate shareholders own 50% or more of the vote and value of the distributing corporation).[532]

b. Base Period

The "base period" is the shorter of either:

(1) the period beginning on the ex-dividend date for the dividend preceding the dividend in question, and ending on the day before the ex-dividend date of the dividend in question; or

(2) the one-year period ending on the day before the ex-dividend date for the dividend in question.[533]

c. Portfolio Indebtedness

Portfolio indebtedness means any indebtedness that is "directly attributable" to the investment in portfolio stock.[534] The "directly attributable" language is the weakness in the conceptual framework of §246A. Given the fungibility of money, the link between debt and investment is not always easy to identify. Without the linkage, however, §246A does not operate. The legislative history indicates that the phrase "directly attributable" encompasses situations involving both the carrying and the acquisition of portfolio stock. The IRS ruled in Rev. Rul. 88-66 that the linkage was not present when a taxpayer acquired a building with funds obtained from a mortgage debt, rather than selling its investment in portfolio stock to finance the acquisition of the building.

In *OBH, Inc. v. United States*,[535] the court examined a more complex situation. The IRS had brought a case against the taxpayer alleging the application of §246A. In rejecting the IRS's argument, the court held that the IRS's attempt to trace the proceeds of the taxpayer's 1988 and 1989 borrowings to its purchases of various dividend-paying stocks in 1989, 1990, and 1991 failed to satisfy either the purpose prong or the directly traceable prong of §246A, and the IRS, therefore, erroneously reduced the taxpayer's DRD relating to those stocks. The court rejected the contention that the taxpayer's "dominant purpose" in incurring the indebtedness was to acquire dividend-paying stock, and noted (i) the "tenuous relationship" between the indebtedness and the dividend-paying stock,[536] (ii) uncontradicted testimony that the taxpayer's dominant purpose, in incurring the debt, was simply to "fortify" the capital base, and (iii) the fact that the taxpayer did not know how the loan proceeds were to be invested until the date on which the proceeds were acquired.[537] The court refused to conclude that the "directly traceable" prong of the "directly attributable" standard was satisfied, noting that the loan proceeds actually needed to be used to buy portfolio stock, while here none of the traces asserted by the IRS agent showed anything like an "immediate connection" between the loan proceeds and the investment in portfolio stocks.[538]

d. Average Indebtedness Percentage

Average indebtedness percentage is derived by dividing the average portfolio indebtedness during the base period by the average basis of the portfolio stock during the base period.[539] If the portfolio stock is not held during the entire base period, the actual holding period is used in the percentage calculation.[540] The average indebtedness percentage is subtracted from 100% to yield the percentage of the otherwise available DRD (50% or 65%) that is allowable.[541]

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[527] §246A(c).

[528] 105 T.C. 71 (1995), *aff'd per curiam*, 183 F.3d 907 (8th Cir. 1999).

[529] T.C. Memo 1998-97.

[530] §246A(c)(2).

[531] §246A(c)(2)(A).

[532] §246A(c)(2)(B).

[533] §246A(d)(4).

[534] §246A(d)(3).

[535] 397 F. Supp. 2d 1148 (D. Neb. 2005).

[536] 397 F. Supp. 2d at 1160. In concluding that the relationship was tenuous, the court pointed to the significant lapse of time between the incurring of the debt and the purchase of dividend-paying stock, the large number of transactions through which the IRS agent traced the loan proceeds, and the IRS agent's arbitrary allocation methodology.

[537] The court considered this a strong factor in rebutting the inference that the taxpayer's dominant purpose in incurring the indebtedness was to acquire portfolio stock.

[538] 397 F. Supp. 2d at 1162–63.

[539] §246A(d)(1).

[540] §246A(d)(2).

[541] §246A(a)(2). For taxable years beginning before January 1, 2018, the applicable DRD percentages were 70% and 80%. For taxable years beginning

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Example: The facts are the same as in the preceding example, with the following additions: Z acquires Y stock on May 1, Year One; the ex-dividend date for the second quarter dividend from Y is June 21, Year One; the ex-dividend date for the first quarter dividend is March 21, Year One; and Z pays off half the loan on June 1, Year One. For purposes of the average indebtedness percentage computation, the base period runs from May 1, Year One (date of acquisition of the Y stock), through June 20, Year One, a period of 51 days. The indebtedness is $100,000 for 31 days of the base period, and $50,000 for 20 days of the base period, yielding an average indebtedness of $80,392 ($60,784 for the period up to June 1, Year One, plus $19,608 for the period thereafter). This average indebtedness is divided by the Y stock basis of $250,000 to yield the average indebtedness percentage of 32%, which is subtracted from 100% to give 68%. As a final calculation, Z is entitled to 68% of the otherwise available DRD.

after December 31, 2017, the TCJA reduced the 70% DRD to 50% and reduced the 80% DRD to 65%. *See* §243(a)(1), §243(c)(1).

e. Limit on Reduction

The reduction of the allowable DRD may not exceed the amount of the interest deduction allocable to the dividend in question.[542] This limit on the DRD reduction is consistent with the statutory purpose of allowing a corporate shareholder to claim either its interest deduction or its DRD, but not both.

Comment: Unlike the preceding limitation, this one probably should not be viewed as mechanical, in spite of its numerous definitions and computations. The limitation cannot be determined from the face of the taxpayer's Form 1120 because of the vagueness of the key phrase "directly attributable." However, the resulting uncertainty may actually help the government's cause by deterring overly aggressive taxpayers from entering into tax-motivated transactions that seek to exploit the DRD.

[542] §246A(e).

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VII. Basis Reduction for Extraordinary Dividends Received by Corporate Shareholders — §1059

A. General

Section 1059 generally requires a corporate shareholder to reduce its stock basis by the nontaxed portion of a dividend if (1) the corporate shareholder has held the stock for two years or less and (2) the dividend is an "extraordinary dividend."[543] An "extraordinary dividend" is defined as a dividend that equals or exceeds 5% of the shareholder's basis in preferred stock or 10% of the shareholder's basis in common stock.

Section 1059 was enacted to prevent a perceived abuse from Congress. Before enactment of §1059, corporations would purchase stock of a corporation that subsequently paid a very large dividend shortly after being purchased. The market value of the acquired stock would drop by approximately the value of the large dividend. Assuming no market fluctuations, the acquiring company would sell the stock for a large loss since the acquiring company's stock basis was not reduced and claim a DRD deduction for the dividend received before the sale.

> *Example:* Before the enactment of §1059 (in 1984), corporation X acquired stock in corporation Y for $100,000; Y subsequently paid a $10,000 dividend to X. In 1984, the DRD was 85%, giving X an $8,500 deduction and leaving $1,500 taxable. The top corporate tax rate in 1984 was 46%, producing a tax of $690 (an effective tax rate of 6.9%). Assuming the post-dividend value of the Y shares fell to $90,000, a sale by X produced a $10,000 capital loss because basis remained unchanged at $100,000. If X had sufficient short-term capital gain to absorb the $10,000 short-term capital loss, the tax benefit was $4,600. The net tax saving on the entire transaction was $3,910 ($4,600 – $690). The tax saving resulted from the lower effective tax rate on the $10,000 of dividend income converted by the DRD into 85% exempt income.

B. Extraordinary Dividends

1. Definition

Within the two-year holding period, §1059 generally takes into account only those dividends likely to lead to tax-driven transactions, so-called "extraordinary dividends." Extraordinary dividends are generally defined quantitatively, according to the type of stock paying the dividend. A dividend on *preferred* stock is treated as extraordinary if it equals or exceeds 5% of the corporate shareholder's adjusted basis in the preferred stock.[544] A dividend on common stock is treated as extraordinary if it equals or exceeds 10% of the corporate shareholder's adjusted basis in the common stock.[545]

[543] §1059(a)(1), §1059(a)(2). *See also* PLR 9534025.
[544] §1059(c)(2)(A).
[545] §1059(c)(2)(B).

2. Aggregation Rules

If each dividend on common stock were tested independently against the 10% threshold, it would be easy to avoid the strictures of §1059 by tailoring each dividend to fall just under the threshold. To prevent this type of avoidance, §1059 requires an aggregation of certain dividends.

a. 85-Day Rule

Successive dividends are aggregated and treated as a single dividend in testing against the 10% threshold if their ex-dividend dates[546] are within 85 days of each other.[547]

> *Example:* Corporation X acquires $100,000 of corporation Y common stock on January 15, Year One. During the first six months of Year One, X receives two dividends from Y, one for $6,000 and one for $5,000. The ex-dividend dates of the two dividends are April 20, and June 20, respectively. Because the two ex-dividend dates are only 61 days apart, they must be aggregated under the 85-day rule and treated as a single dividend in testing against the 10% threshold. As aggregated, they exceed the threshold ($11,000/$100,000 = 11%) and are treated as extraordinary. Taken separately, they would not be treated as extraordinary because each would fall below the threshold.

Note: A dividend cannot be pushed in two different directions under the aggregation rules. Once accelerated to combine with an earlier dividend, it cannot then be deferred to combine with a subsequent dividend.[548] For instance, when the second dividend is combined with the first in the example above, the second cannot be combined with a third dividend that has an ex-dividend date within 85 days of the ex-dividend date of the second (June 20, Year One). Technically, once the second dividend is combined with the first, the second dividend is treated as having the same ex-dividend date as the first dividend (April 20, Year One).

b. 365-Day Rule

A corporation could pay several dividends, each just under the 10% threshold, within the same year while avoiding the extraordinary classification by spreading them more than 85 days apart. To prevent this type of avoidance, another aggregation rule groups together all dividends paid within the same 365-day period and treats them as one in testing against a special 20% threshold.[549]

> *Example:* The facts are similar to those in the preceding example, except that the ex-dividend date of the first dividend is March 20, not April 20. Because the ex-dividend dates of the two dividends are now 92 days apart, they are not aggregated under the 85-day rule. Accordingly, neither is treated as extraordinary because each falls below the 10% threshold. If X receives another dividend in Year One for $5,000, and another early in Year Two for $4,500, the

[546] §1059(d)(4).
[547] §1059(c)(3)(A).
[548] Rev. Rul. 88-49.
[549] §1059(c)(3)(B).

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ex-dividend dates for the latter two dividends are September 20, and January 20, respectively. None of these dividends are aggregated under the 85-day rule because their ex-dividend dates are more than 85 days apart. However, the ex-dividend dates are within the same 365-day period and are thus aggregated for purposes of the special 20% threshold. As aggregated, they exceed the threshold ($20,500/$100,000 = 20.5%). Therefore, the aggregated dividends constitute extraordinary dividends pursuant to §1059.

3. *Adjusted Basis*

Generally, the denominator of the threshold test is the adjusted basis of the underlying stock.[550] As noted above, the §1059 basis reduction upon the receipt of an extraordinary dividend occurs at the beginning of the ex-dividend date.[551]

A corporate shareholder has the option of substituting fair market value for adjusted basis in applying the threshold tests.[552] However, the corporate shareholder must satisfy the IRS as to the fair market value before using this option.[553]

C. Basis Reduction and Gain Recognition

1. *Nontaxed Portion of Dividend*

Section 1059 generally reduces stock basis by the nontaxed portion of the extraordinary dividend (but not below zero).[554] The nontaxed portion is the excess of the gross dividend over the taxable portion.[555] The taxable portion is the gross dividend less the applicable DRD.[556] In other words, the nontaxed portion is generally equal to the amount of the DRD. The TCJA amended §1059 to include dividends received under §245A in the calculation of the reduction of a corporate shareholder's basis.[557]

2. *Timing*

The reduction in basis generally occurs at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.[558] If the amount of the reduction exceeds basis, the excess is treated as gain from the sale or exchange of the stock for the tax year in which the extraordinary dividend is received.[559]

3. *Holding Period*

Section 1059 does not require a basis reduction if the stock has been held for more than two years before the "dividend announcement date."[560] This is the date on which the corporation declares, announces, or agrees to the amount or payment of the dividend, whichever is the earliest.[561]

4. *Exception*

Section 1059(d)(6) excludes an extraordinary dividend from §1059(a) treatment if the distributee is an original shareholder of the distributing corporation and the earnings and profits from which the dividend is paid are attributable to the original shareholder. However, Reg. §1.1059(e)-1(a) provides that the exception in §1059(d)(6) does not prevent a distribution that is treated as an extraordinary dividend under §1059(e)(1) (relating to partial liquidations and certain redemptions[562] from being treated as an extraordinary dividend).

D. Overall Exception for Affiliated Groups

Generally, §1059 does not apply to dividends paid within an affiliated group, i.e., dividends eligible for the 100% DRD under §243.[563] It would be redundant to apply the basis reduction sanction of §1059 to affiliated groups filing consolidated returns because a basis reduction for distributions is the norm in the consolidated return regulations.[564] In addition, when basis reductions exceed actual basis, the consolidated return regulations provide for the creation of an excess loss account (essentially equivalent to a negative basis that is recognized as gain

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[550] §1059(c)(1).

[551] §1059(d)(1).

[552] §1059(c)(4).

[553] §1059(c)(4). *See* Rev. Proc. 87-33 (explaining procedures for establishing fair market value). *See also* PLR 9621009 (appraised value of preferred stock accepted for §1059(c)(4) election), PLR 9542035 (extension of time to file request for valuation under §1059(c)(4) granted); FSA 199940011 (to benefit under §1059(c)(4), taxpayer does not have to follow rules under Rev. Proc. 87-33 that are clearly procedural but must establish fair market value of subsidiary's stock).

[554] §1059(a)(1).

[555] §1059(b)(1).

[556] §1059(b)(2).

[557] §1059(b)(2)(B). For a detailed discussion of §245A, see VI.D.6., above.

[558] §1059(d)(1). Before the changes made by the 1997 Taxpayer Relief Act (TRA), Pub. L. No. 105-34, the reduction in basis occurred when the stock was sold, not when the dividend was distributed. Pre-1997 §1059(d)(1)(A). Thus, if the amount of the reduction exceeded basis, the excess was treated as gain on the sale of stock at the time of disposition. Pre-1997 §1059(a)(2). Congressional action in amending §1059 in the 1997 TRA was reportedly precipitated by a well-publicized transaction, the "Seagram Trade." Seagram had an "old and cold" interest in DuPont, amounting to nearly 25% of the latter (i.e., a level entitling Seagram to the 80% DRD under §243(c)). Seagram's basis in the DuPont stock was approximately $3 billion, while its market value was approximately $10 billion. Seeking to divest its DuPont holdings, but not at the cost of paying an enormous capital gain tax, Seagram opted for a less costly alternative. First, Seagram obtained warrants to purchase additional DuPont stock. Next, Seagram offered to sell 95% of its Dupont holdings back to DuPont, at a substantial discount (reportedly $1 billion). (The significance of the 5% retainage quickly became apparent.) DuPont accepted the offer and redeemed 95% of Seagram's stake. Relying on Rev. Rul. 89-64, which treated a redeeming shareholder as owning stock subject to option (the stock warrants), Seagram claimed the redemption proceeds fell outside the ambit of §302(b)(2) and, thus, did not qualify for sale or exchange treatment under §302(a) but, instead, should be treated as a §301 distribution under §302(d). *But see* PLR201918009 (redemption was not treated as a sale or exchange because it was an isolated transaction and the taxpayer received fair market value for its shares). This was the object of the exercise, because a §301 distribution would bring with it the 80% DRD. As discussed below, the non pro rata nature of the distribution meant that it was an extraordinary dividend under §1059(e)(1). The consequence of this treatment was that Seagram had to reduce its basis in its 5% *retained* DuPont stock interest by the amount of the DRD, producing a virtual negative basis in the retained stock. However, under the law in effect at the time (April 1995), the negative basis account would *not* be triggered until Seagram sold the retained stock. Under the 1997 amendment to §1059, this amount had to be reported in the year in which the extraordinary dividend is received. The effective date of the amendment was May 3, 1995, a month too late to catch the Seagram Trade.

[559] §1059(a)(2).

[560] §1059(a).

[561] §1059(d)(5).

[562] See VI.E.1., above.

[563] §1059(e)(2)(A) (reference to §243 qualifying dividends).

[564] Reg. §1.1502-32.

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upon the occurrence of certain events).[565] While the exception applies regardless of whether the affiliated group files a consolidated return, it is not available for dividends from earnings and profits that are earned before affiliation or are attributable to built-in gain at affiliation.[566]

Because distributions in the affiliated group context most often arise out of earnings and profits generated during the subsidiary's affiliation, this exception to the exception is rarely invoked.

Reg. §1.1059(e)-1(a) serves as another exception to the affiliated group exception. Reg. §1.1059(e)-1(a) requires extraordinary dividend treatment for distributions in partial liquidation, redemption, or reorganization that are treated as extraordinary dividends under §1059(e)(1), discussed below, regardless of whether they would otherwise escape extraordinary treatment. In the preamble to these regulations, the IRS indicated that applying the affiliated group exception to dividends deemed extraordinary under §1059(e)(1) was inconsistent with the purpose of §1059 and could create inappropriate consequences such as basis shifting resulting in an artificial loss.[567]

Note: These regulations were proposed and finalized under former §1059, which deferred the gain recognition until disposition of the stock. Consequently, affiliated groups filing consolidated returns received treatment similar to the treatment of those not filing consolidated returns, by virtue of the consolidated return regulations requiring basis adjustments and deferral of gain recognition regardless of whether the distribution constituted an extraordinary dividend. The 1997 legislation drastically changed the treatment between consolidated groups and separate return affiliated groups leaving uncertainty as to whether the consolidated return regulations controlled distributions governed by §1059(e)(1). While acknowledging the validity of the IRS's concerns with respect to affiliated groups that do not file consolidated returns, Congress has clearly stated its intent to exempt consolidated groups from §1059(e)(1) treatment.[568] In 1998, Congress amended §1059(g) to authorize the promulgation of regulations concerning affiliated groups filing consolidated returns. This amendment was effective for distributions after May 3, 1995, a date before the effective date of the regulations.[569] In the corresponding legislative history, Congress stated that the authorization of such regulations would render §1.1059(e)-1(a) inapplicable to distributions within consolidated groups that otherwise would require negative basis adjustments.[570] The IRS seemingly followed Congressional intent in PLR 9815050, in which it indicated that no basis adjustment was required in the case of an extraordinary dividend under §1059(e)(1) if basis adjustments were made under Reg. §1.302-2 or Reg. §1.1502-32.[571]

[565] Reg. §1.1502-19.

[566] §1059(e)(2)(B).

[567] *See* T.D. 8724, 62 Fed. Reg. 38,027 (July 16, 1997).

[568] Staff of the Joint Comm. on Tax'n, "General Explanation of Tax Legislation Enacted in 1997," JCS-23-97, at 196 (1997).

[569] The 1998 IRS Restructuring and Reform Act, Pub. L. No. 105-206, §6010(b).

[570] *See, e.g.*, H.R. Rep. No. 105-599, at 340 (1998) (Conf. Rep.).

[571] Reg. §1.302-2 has not been amended to reflect the Regulated Investment Company Act of 2010, Pub. L. No. 111-325.

E. Basis Recovery Under §304(a)(1) Transactions

Under §304(a)(1), a corporation that acquires stock of another corporation under common control (brother-sister companies) is treated as a redemption by the acquiring corporation. If the deemed redemption is not described in §302(a) or §303, §302(d) applies, and it is treated as a distribution under §301. A fiction is thus created that the transferor and the acquiring corporation are treated as if the transferor had transferred the stock to the acquiring corporation in a §351 transaction and, then, the acquiring corporation redeems the fictional stock that it was treated as having issued. As a result, the sales proceeds are first taxed as a dividend under §301(c)(1) based on the combined E&P of both the transferor and acquiring corporations.

Although §304 is not applicable to transactions between members of a group of corporations that file a consolidated return, it is applicable to corporations that satisfy a 50% ownership test in §304.[572] As discussed above, §1059 requires that stock basis be reduced based on the non-taxed distribution if an extraordinary dividend is paid because the corporation receiving the distribution receives a DRD. In the context of a transaction where §304(a)(1) applies, §1059 applies to the redemption of only the shares received in the fictional §351 transaction if the DRD exceeds the basis in the newly issued stock.[573]

F. Special Rules

1. Certain Redemptions

As alluded to above, certain redemptions are treated as extraordinary without regard to either the threshold tests or the holding period requirements. These automatic extraordinary dividends are the dividend portion, if any, of:

(1) distributions in partial liquidation;[574]

(2) non-pro rata redemptions;[575] or

[572] Reg. §1.1502-80(b).

[573] There is no current guidance as to whether the portion of the DRD that is reduced because there is less than 80% ownership of the corporation (but more than 50%) allows the issuer to retain additional stock basis in its remaining shares.

[574] §1059(e)(1)(A)(i). There are two main requirements under §302(b)(4) for a redemption to qualify as a partial liquidation. First, the distribution is considered not essentially equivalent to a dividend under §302(e)(1)(A). Section 302(e)(2) contains a safe harbor under which a distribution attributable to the corporation ceasing to conduct one qualifying trade or business while continuing to conduct another qualifying trade or business or a distribution that results from genuine contraction of the corporate business is considered not essentially equivalent to a dividend. Second, there should be plan of liquidation as required under §302(e)(1)(B).

[575] §1059(e)(1)(A)(ii). In CCA 200924041, the Chief Counsel's office advised that the treatment of redemption proceeds as a dividend and the shifting of the basis of the redeemed shares to the non-redeemed shares, followed by the reduction in the basis of the non-redeemed shares by the "non-taxed" portion of the redemption distribution was proper. *See also* Robert Willens, "IRS Addresses Basis Recovery for Extraordinary Dividends?" 121 DTR J-1 (June 26, 2009), for further discussion of CCA 200924041. *See* PLR 9346020 (redemption of preferred stock was not extraordinary dividend within meaning of pre-1997 TRA §1059(e)(1)(B)), PLR 9534025 (revoking PLR 9346020 without explanation). In TAM 200023003, the IRS interpreted the pro-rata distribution test of §1059(e)(1)(A)(ii) as including all shareholders of a corporation, not just holders of the stock class redeemed.

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(3) redemptions that would not have been treated as a dividend if any options had not been taken into account under §318(a)(4) or if §304(a) had not applied.

A dividend that is treated as an extraordinary dividend because of §1059(e)(1) is treated as such even if it otherwise qualifies for the "original shareholder" exception in §1059(d)(6), discussed at VII.B., above. Similarly, the dividend is extraordinary even if it is otherwise within the "qualifying dividend" exception in §1059(e)(2), discussed at VII.D., above.[576] The IRS has indicated that, if a redemption of stock is not pro rata as to all shareholders, any amount treated as a dividend under §301 is an extraordinary dividend regardless of whether the dividend is a qualifying dividend.[577] As previously mentioned, consolidated return regulations govern qualified dividends distributed within groups filing consolidated returns.[578]

Note: The rule on partial liquidations might seem irrelevant because corporate shareholders are not eligible under §302(b)(4)(A) for partial liquidation treatment. Nevertheless, all shareholders (including corporate shareholders) can receive distributions in partial liquidation, because the determination of partial liquidation treatment is made at the level of the distributing corporation under §302(e)(1)(A).[579]

In CCA 200924041, the Chief Counsel's office advised permitting a taxpayer to shift the basis reduction from a redemption that was treated as an extraordinary dividend between the redeemed stock and the nonredeemed stock pro rata followed by a reduction in the basis of the nonredeemed shares by the nontaxed portion of the distribution.[580]

Reorganizations or other exchanges involving amounts that are treated as dividends under §356 are treated as redemptions for purposes of applying the rules relating to redemptions under §1059(e). For example, if a recapitalization or other transaction that involves a dividend under §356 has the effect of a non pro rata redemption or is treated as a dividend because options are counted as stock, the rules of §1059 apply. Redemptions of shares, or other extraordinary dividends on shares, held by a partnership are subject to §1059 to the extent there are corporate partners (e.g., to the extent appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest are required).[581]

Practice Point: The test to determine whether the shareholder receives sale or exchange treatment on the redemption or dividend treatment is based on the shareholder's information. Redemptions of stock for publicly traded corporations can be particularly challenging in applying the rules of §302. In determining its stockholdings under the §302 test, a shareholder may own the redeemed corporate stock in multiple brokerage accounts and must also apply the attribution rules of §318(a) to take into account the stock it owns as well as stock constructively owned.[582] This makes it difficult for the redeemed corporation to have all the facts to apply the tests under §302. A public corporation will thus often leave the determination of the federal income tax treatment of the redemption up to the shareholder to determine in a share buy back when it files a Form 8937, *Report of Organizational Actions Affecting Basis of Securities*. As described above, a corporation may be required to withhold taxes on taxable dividend distributions supported by earnings and profits. In the case of redemptions, corporations generally withhold from the sales proceeds and assume the redemption will be treated as a dividend even though most of the redemptions receive sale or exchange treatment. A complicating factor arises when a stock redemption is for like kind property, such as notes in the issuer, and the treatment under §302 is unknown.[583]

Redemptions of preferred stock can also cause difficulties in determining whether the redemptions are considered dividends or sales or exchanges under §302. If a shareholder owns only nonvoting preferred shares that are not characterized as stock under §306, the redemption would qualify under §302(b)(1). When a shareholder owns a combination of voting common and nonvoting shares, a redemption of either or both may be treated as a dividend. If a shareholder owns more than 50% of the voting common stock and corporation redeems only the nonvoting preferred stock, the shareholder cannot satisfy the safe harbor of §302(b)(2) because the shareholder's voting stock percentage remains the same both before and after the redemption. Reg. §302-3(a), however, states that §302(b)(2) ap-

[576] Reg. §1.1059(e)-1(a).

[577] *See* T.D. 8724, 62 Fed. Reg. 68,167 (Dec. 31, 1997).

[578] See VII.D., above.

[579] *See* PLR 202210005 (S corporation distributions made to its shareholders under an agreement to pay federal, state, and local income taxes on their allocable shares of S corporation income are not considered distributions in partial liquidation). *See also*, *Imler v. Commissioner*, 11 T.C. 836 (1948) (corporation's distribution of excess insurance proceeds resulted in partial liquidation and not distribution essentially equivalent to a dividend); Rev. Rul. 74-296 (discontinuation of business activities resulted in genuine corporate contraction and therefore distribution to shareholders qualified as a partial distribution); PLR 8641032, *supplemented by* PLR 8707012 (pro rata distribution to shareholders of fire insurance proceeds and portion of condemnation award pursuant to a plan of liquidation, after destruction of separate and distinct business operated by taxpayer, qualified under §302(e)(1) and treated as distribution in partial liquidation under §302(b)(4); §302(e)(2) not applicable so representation of active conduct of a trade or business for five years preceding the distribution unnecessary).

[580] CCA 200924041.

[581] Staff of the Joint Comm. on Tax'n, "General Explanation of Tax Legislation Enacted in 1997," JCS-23-97, at 196 (1997).

[582] Fractional shares purchased in a reorganization are treated as a redemption under §317, but are subject to the rules of §302. Rev. Rul. 66-365 ("In all reorganizations described in the preceding paragraphs where the cash payment made by the acquiring corporation is not bargained for but is in lieu of fractional share interests to which the shareholders are entitled, such cash payment will be treated under §302 of the Code as in redemption of the fractional share interests. Therefore, each shareholder's redemption will be treated as a distribution in full payment in exchange for his fractional share interest under §302(a) of the Code provided the redemption is not essentially equivalent to a dividend"). A non-corporate shareholder may waive attribution of family member ownership for redemptions under §302(b)(3) if it complies with the requirements of §302(c)(2)(A). To meet the requirements of §302(c)(2)(A), the shareholder must not immediately after the redemption, have an "interest" in the corporation, including an interest as an officer, director, or employee (other than an interest as a creditor); must not, within the ensuing 10 years, acquire any such interest, other than stock acquired by bequest or inheritance, and must agree to notify the IRS of the acquisition of an interest in the corporation during the 10-year period beginning on the date of the redemption. For example, an executor of a will who can vote shares in the redeeming corporation after the agreement is filed with the IRS does not constitute the acquisition of a prohibited interest in the corporation but instead was in the bequest or inheritance exception in §302(c)(2)(A)(ii). *See also* Rev. Rul. 79-334.

[583] See Robert Willens, "Exela Technologies Launches Unusual Self Tender Offer," 174 *Tax Notes Federal* 987 (February 14, 2022) (corporate shareholders were required to make a payment to the company for the withholding taxes).

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plies only to a redemption of voting stock or a combination of both. The question then becomes whether §302(b)(1) applies to treat the redemption as essentially not equivalent to a dividend.[584] Treatment of a redemption of nonvoting preferred stock when a shareholder owns common voting stock may be dependent on the amount of control the shareholder possesses through its ownership of voting stock and the loss of economic interest in the corporation.[585]

Practice Point: Shareholders that own both voting and nonvoting stock may want to consider redeeming nonvoting preferred stock along with a planned redemption of voting common stock in the same transaction to ensure sale or exchange treatment if the shareholder possesses a significant amount of control of the corporation post redemption.

2. Qualified Preferred Dividends

As an exception to §1059(c)(2), "qualified preferred dividends" are exempt from the extraordinary dividend rules by classifying a portion of the dividend as extraordinary.[586] The objective of this exception is to catch only the portion of preferred dividends that represents the excess of the actual yield over the stated yield. An investor can boost actual over stated yield by shortening its holding period.

> *Example:* An investor holding 12% preferred (payable semi-annually) for 21 months "earns" 175% ($21) of the stated annual dividend. However, if the 21-month holding period spans four dividend payments, the investor's actual yield is 13.7% (($24/$100)/1.75 years). In effect, the investor has received three months of income earned by another party. The purpose of the secondary screening is to catch the $3 incremental yield, while letting the $21 basic yield pass. Although achieving greater accuracy, the secondary screening reaches almost byzantine complexity.

To be eligible for the secondary screening, the dividend must be a "qualified preferred dividend." Preferred stock paying a "qualified preferred dividend" has all three of the following characteristics:

(1) it must pay a fixed amount at least once a year;

(2) it cannot have dividends in arrears when the investor acquires it; and

(3) it cannot have an actual rate of return in excess of 15%.[587]

If the taxpayer holds the preferred stock for more than five years, no basis reduction is required with respect to any portion of the qualified preferred dividends.[588] If the corporate shareholder does not hold the stock for at least five years, then the aggregate basis reduction under §1059(a)(1) cannot exceed the excess of actual qualified preferred dividends paid over the amount of qualified preferred dividends that would have been paid during the period the shareholder held the stock based on the stated rate of return.[589]

a. Actual Rate of Return

The actual rate of return is calculated by dividing the annual average of the actual dividends received by the corporate shareholder by the lesser of the stock's adjusted basis or its liquidation preference.[590]

> *Example:* On January 1, Year One, corporation X pays $10,000 to purchase 100 shares of corporation Y's preferred stock, which pays a dividend of $6 per share semi-annually on March 31 and September 30. No dividends are in arrears and the liquidation preference is $100. X holds the stock for a year and three-quarters, selling it on October 1, Year Two, after collecting four semi-annual dividends for a total of $24 per share. The actual dividend collected of $24 per share represents an average annual dividend of $13.71 ($24/1.75 years). X's actual rate of return is thus 13.7% ($13.71/$100). Because its actual rate of return is less than 15%, and the stock pays a fixed annual dividend with no dividends in arrears at the time of investment, the dividends paid should constitute qualified preferred dividends. As discussed below, the stock must be held for at least five years to eliminate the need for a basis reduction. In these facts, however, the stock was not held for more than five years. Therefore, the stated rate of return must be compared to the actual rate of return to determine if a basis reduction is necessary.

b. Stated Rate of Return

The stated rate of return is calculated by dividing the stated (or fixed) amount of dividends payable to the corporate shareholder during its holding period for the stock by the lesser of its adjusted basis or its liquidation preference.[591]

> *Example:* On the same facts as in the preceding example, the stated rate is 12% ($12 annual dividend divided by $100 liquidation preference).

c. Extraordinary Portion

The extraordinary portion of dividends received during the holding period is the difference between the actual and stated rates.[592]

> *Example:* On the same facts as in the preceding example, the excess rate of return equals 1.7% (13.7% – 12%). Expressed as a fraction of the actual dividend rate, 12.4% (1.7%/13.7%) of each dividend constitutes the extraordinary portion. Thus, $.74 of each $6 dividend payment (12.4% × $6) is considered extraordinary. For the full

[584] *See Himmel v. Commissioner*, 338 F.2d 815 (2d Cir. 1964) (a redemption of nonvoting preferred stock held by a shareholder who constructively owned 50 percent of the voting common stock was not equivalent to a dividend because the shareholder received a greater amount of cash than he would have received if a hypothetical "dividend" had been paid on the common stock). *See also United States v. Davis*, 397 U.S. 301 (1970).

[585] *See* Robert Willens, "Redemptions of Preferred Stock," *Tax Notes* (Jan. 29, 2007).

[586] §1059(e)(3).

[587] §1059(e)(3)(C).

[588] §1059(e)(3)(A)(i).

[589] §1059(e)(3)(A)(ii).

[590] §1059(e)(3)(B)(i).

[591] §1059(e)(3)(B)(ii).

[592] §1059(e)(3)(A)(ii).

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holding period, the extraordinary portion of the four dividends is \$2.96 (4 × \$.74). With allowance for rounding, this corresponds to the incremental yield of \$3 that the taxpayer realized by holding the stock for only 1.75 of the 2 years intended by the stated rate of return (\$24 − (\$12 × 1.75)). As stated in the introductory example, this incremental yield is exactly what the secondary screening is intended to trap.[593]

Note: If X had retained its Y preferred stock for three more months, i.e., until January 1, Year Three, X's actual rate of return for the extended holding period would be 12% ((\$24/\$100)/2 years). Because the actual rate of return would equal the stated rate of return, no portion of X's dividends would be treated as extraordinary.[594]

3. *Disqualified Preferred Stock ("Self-Liquidating" Stock)*

To obtain the special treatment accorded qualified preferred stock, a product called "self-liquidating preferred" was developed. This product had a high yield, up to 15% (but no higher, because 15% is the allowable limit upon qualified preferred dividends). It had a declining dividend rate and a decreasing redemption or call price that, at the end of a given period, approached zero (hence the label "self-liquidating"). To protect the integrity of the qualified preferred dividend rules, a new defensive category was created: "disqualified preferred stock."[595] All dividends on "disqualified preferred stock" are treated as extraordinary, regardless of the length of the holding period.[596] "Disqualified preferred stock" is defined as preferred stock:

(1) the dividend rate of which declines (or reasonably can be expected to decline) in the future;[597] and

(2) the issue price of which exceeds its liquidation value or stated redemption price.[598]

Finally, as a warning to taxpayers not to get too creative, disqualified preferred stock includes any preferred stock that is structured to avoid the extraordinary dividend rules, i.e., that combine the DRD with an artificial loss on sale of the underlying stock.[599] In addition, the IRS is authorized to extend these rules to common stock if similar abuses develop.[600]

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593 This example, in its entirety, was presented in the legislative history. *See* H.R. Rep. No. 99-841, at II-165 (1986) (Conf. Rep.).

594 *See* H.R. Rep. No. 99-841, at II-165 (1986) (Conf. Rep.).

595 *See* §1059(f).

596 §1059(f)(1).

597 §1059(f)(2)(A).

598 §1059(f)(2)(B).

599 §1059(f)(2)(C).

600 §1059(g)(2).

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VIII. Taxation of Distributing Corporation

A. Background

Section 311 contains the rules governing the taxation of the distributing corporation on current (i.e., nonliquidating) distributions.

Although §311(a) provides a general rule of nonrecognition for gains and losses on distributions made by a corporation with respect to its stock, §311(b) provides that gain will be recognized by the distributing corporation when the fair market value of any property distributed exceeds its adjusted basis (in the hands of the distributing corporation). The 1986 TRA thus gutted the nonrecognition rule for gains while preserving it for losses.

B. General

Section 311 focuses on "distributions in kind," a term used generally to refer to distributions of property other than cash or the distributing corporation's own stock or rights to acquire such stock. From the standpoint of the corporate income tax, the distribution of cash is a nonevent because the cash has a basis equal to its fair market value. On the other hand, distributions of the corporation's own stock or stock rights are covered by other sections of the Code.[601] Because property (other than cash) seldom has a value exactly equal to its basis, a distribution in kind invariably involves either gain or loss.

1. Gains

As indicated above, the §311(a) nonrecognition rule for gains is virtually canceled by §311(b)(1). Therefore, the distributing corporation is likely to recognize gain, if any, on the distribution of appreciated property.

a. Generally

Current distributions covered by the gain recognition rule of §311(b)(1) are those "to which subpart A applies."[602] The statutory model for recognizing gain under §311(b)(1) is a hypothetical sale of the appreciated property at its fair market value to the distributee. If a liability assumed by the distributee exceeds the property's fair market value (or the property is taken subject to a liability), §311(b)(2) requires that the property's fair market value be treated as at least equal to the amount of the liability.

In *Pope & Talbot, Inc. v. Commissioner*,[603] the Ninth Circuit considered the amount of gain that should be recognized under §311 by a corporation distributing appreciated realty to a limited partnership, which in turn made a nonliquidating distribution of the limited partnership interests to the corporation's shareholders as a dividend. The Ninth Circuit held that the gain on the corporation's distribution of the appreciated realty was to be determined as if the corporation had sold the realty at the time of distribution to the limited partnership, not by aggregating the value of individual limited partnership units distributed to the shareholders. The court pointed out that the language of §311 specifically refers to the fair market value of the property "in the hands of the distributing corporation." The court rejected the taxpayer's position that the fair market value of the property distributed by a corporation should equal the fair market value of the property in the form (limited partnership units) in which the shareholders received it.

The IRS reached the same conclusion in TAM 200443032, in which a corporation contributed assets to several limited partnerships in exchange for partnership interests. The corporation then distributed the limited partnership interests to its own shareholders and retained only general partnership interests for itself. The IRS ruled that the corporation was taxable under §311(b) based on the value of the assets it contributed rather than the (lower) value of the partnership interests it distributed to its shareholders.[604]

b. Exclusions

Left unaffected by the gain recognition rule of §311(b)(1) are those distributions outside of subpart A of part I: liquidating distributions (part II), and distributions in connection with reorganizations (part III). The first exclusion is merely territorial, because liquidating distributions are subject to their own gain recognition rules.[605] The second exclusion is substantive, however, principally because it leaves intact the §311(a) nonrecognition-of-gain rule for §355 distributions.

2. Losses

As indicated above, nonrecognition of losses on current distributions continues to be the rule. This nonrecognition rule for losses creates a double lack of symmetry: first, with respect to gains on current distributions and, second, with respect to losses on liquidating distributions. Almost all current gains are recognized,[606] as are many liquidating losses[607] (subject to certain restrictions).[608] The legislative history provides no explanation for this asymmetrical pattern.

Practice Point: Of note, S corporation property distributions may not be taxed as dividends to shareholders but remain taxable under §311(a) to the S corporation.

C. Stock Repurchase Excise Tax

Section 4501(a) levies a nondeductible excise tax on certain repurchases of corporate stock, applicable to repurchases, acquisitions, issuances, and provisions of stock occurring after

[601] *See* §305. For a detailed discussion of §305, see 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*

[602] This refers to subpart A of part I of subchapter C, i.e., §301–§307. See *UNUM Corp. v. United States*, 130 F.3d 501 (1st Cir. 1997), in which the court cited §311, §162(k)(1), §354(a), and §1032(a) for the proposition that an insurance company cannot take a deduction under §805 for cash distributed during a demutualization, and noted that none of these provisions exclude insurance companies from their scope; the general corporate tax provisions of subchapter C apply to insurance companies unless subchapter L makes a specific provision to the contrary.

[603] 162 F.3d 1236 (9th Cir. 1999), *aff'g* 104 T.C. 574 (1995).

[604] *But see* PLR 200934013 that distributed LLC units taxed as a partnership were equal in value to the underlying assets of the partnership. *See also* Deanna Walton Harris, *LTR. RUL. 200934013 — Was the Reference to Pope & Talbot Correct?* J. of Corp. Tax'n (Mar./Apr. 2010).

[605] §336. For a detailed discussion of this subject, see 784 T.M., *Corporate Liquidations.*

[606] §311(b)(1).

[607] §336(a).

[608] §336(d).

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December 31, 2022.[609] The amount of the excise tax is equal to 1% of the repurchasing corporation's (a "covered corporation") stock repurchase excise tax base for the taxable year.[610]

A "covered corporation" that repurchases its own stock within the same taxable year is subject to the excise tax, unless an exception applies, although acquisition of stock by a "specified affiliate" of the covered corporation is also treated as a repurchase by the covered corporation of its own stock.[611] A covered corporation is a domestic corporation traded on an established securities market (within the meaning of §7704(b)(1)).[612]

For purposes of the excise tax, a "repurchase" is either a §317(b) redemption (with certain exceptions)[613] or an "economically similar transaction."[614] Notably, brother-sister stock sales under §304(a)(1) are not treated as repurchases for purposes of the excise tax.[615]

Section 4501(e) lists six types of transactions to which the excise tax does not apply.[616] Among these statutory exceptions, a repurchase is not subject to §4501(a) to the extent it is treated as a distribution of a dividend under §301(c)(1) or §356(a)(2).[617]

Practice Point: Characterizing redemptions as dividends for federal income tax purposes therefore has importance not only to the shareholder, but also to the corporation making the distribution. As discussed in VII.E., above, §302(d) characterizes a corporate stock redemption that does not qualify for sale or exchange treatment under §302(a) as a "distribution to which §301 applies." Thus, corporate stock redemptions that would otherwise be subject to the excise tax, which are treated as distributions and supported by corporate earnings and profits, may be exempt from the stock repurchase excise tax.

A repurchase to which §302 or §356(a) applies is presumed to be subject to §302(a) or §356(a)(1), respectively, and, therefore, is presumed to be ineligible for the §4501(e)(6) dividend exception.[618] A covered corporation may rebut the presumption of no dividend-equivalence with regard to a specific shareholder by establishing with sufficient evidence that the covered corporation and the shareholder treat the repurchase as a dividend on their respective federal income tax return.[619]

A covered corporation, or person treated as a covered corporation, other than a RIC or a REIT, that makes a repurchase, or that is treated as making a repurchase, must:

(i) keep accurate records reflecting the amount of repurchases, adjustments, and/or exceptions required to be shown on its return;

(ii) file Form 720, *Quarterly Federal Excise Tax Return*, to report tax due with respect to any taxable year in which a repurchase is made;

(iii) complete and attach Form 7208, *Excise Tax on Repurchases of Corporate Stock*,[620] to calculate tax owed; and

(iv) pay in full any stock repurchase excise tax liability at the time of filing Form 720.[621]

For further discussion of the stock repurchase excise tax, see 767 T.M., *Redemptions*, at X.G.1.

[609] §4501(a), *added by* the Inflation Reduction Act of 2022, Pub. L. No. 117-169, §10201; Reg. §58.4501-1(a), T.D. 10037, 90 Fed. Reg. 53,144 (Nov. 24, 2025). For a detailed discussion of the stock repurchase excise tax, see 767 T.M., *Redemptions*, at X.G.1.

[610] §4501(a); Reg. §58.4501-2(b), T.D. 10037.

[611] §4501(c)(2)(A); Reg. §58.4501-1(a). A specified affiliate is any corporation more than 50% of the stock of which is owned (by vote or value), directly or indirectly, by such corporation, and any partnership more than 50% of the capital interests or profits interests of which is held, directly or indirectly, by such corporation. §4501(c)(2)(B); Reg. §58.4501-1(b)(32). Additionally, §4501(d) applies the excise tax to stock repurchases or acquisitions of stock of certain foreign corporations. *See* Reg. §58.4501-7, T.D. 10037.

[612] §4501(b); Reg. §58.4501-1(b)(7).

[613] §4501(c)(1); Reg. §58.4501-2(e)(2). Reg. §58.4501-2(e)(3) provides an *exclusive* list of §317(b) redemptions that are not "repurchases" subject to the excise tax: 1) an acquiring corporation's deemed distribution in redemption of its stock resulting from the application of §304(a)(1); 2) a redemption by a covered corporation that is part of a transaction in which the covered corporation ceases to be a covered corporation (e.g., a leveraged buyout or a take-private transaction); 3) a redemption of stock issued before August 16, 2022, if, since issuance, the stock has been subject to a mandatory redemption by the covered corporation or a unilateral put option by the holder; and 4) payments by a covered corporation of cash in lieu of a fractional share of the covered corporation's stock. Reg. §58.4501-2(e)(5) provides a *nonexclusive* list of other types of transactions that are *not repurchases*, including distributions in complete liquidation or dissolution, divisive transactions under §355 that are not split-offs, nonredemptive distributions subject to §301(c)(2) or §301(c)(3), acquisitive reorganizations if the acquisition of target corporation stock is in exchange for property permitted to be received by target shareholders under §354 or §356; net cash settlements of an option contract or other derivative financial instrument; and certain repurchases from a specified affiliate.

[614] §4501(c)(1); Reg. §58.4501-2(e)(2). Reg. §58.4501-2(e)(4) provides an *exclusive* list of transactions that are "economically similar" to a §317(b) redemption: 1) E reorganizations; 2) split-offs; and 3) certain forfeitures and clawbacks of stock.

[615] Reg. §58.4501-2(e)(3)(i)(A). For discussion of brother-sister stock sales under §304, see VII.E., above.

[616] For a detailed discussion of the statutory exceptions, see 767 T.M., *Redemptions*, at X.G.1.c.(3).

[617] §4501(e)(6); Reg. §58.4501-3(g), T.D. 10037.

[618] Reg. §58.4501-3(g)(2)(i).

[619] Reg. §58.4501-3(g)(2)(ii). For discussion of the sufficient evidence requirement, see 767 T.M., *Redemptions*, at X.G.1.c.(3)(e).

[620] *See* Instructions for Form 7208, *Excise Tax on Repurchase of Corporate Stock*.

[621] Reg. §58.6001-1, §58.6011-1, §58.6151-1. A covered corporation is not required to file a stock repurchase excise tax return or pay the tax due before the due date of Form 720 for the first full calendar quarter after June 28, 2024, if the covered corporation has a taxable year ending after December 31, 2022, and on or before June 28, 2024. Reg. §58.6071-1(c).

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IX. Dividends — Members of a Consolidated Group

A. General

Sections 1501 through 1504, and the regulations thereunder, permit an affiliated group of corporations to file a consolidated federal income tax return.[622] The consolidated return regulations supersede the general rules applicable to corporate dividend distributions and treat distributions made within the consolidated group as if they were made between divisions of a single company for purposes of computing consolidated tax liability. To treat members of a consolidated group as if they were divisions, while maintaining their separate entity status, Treasury devised an intercompany transaction system.

The consolidated return regulations treat a dividend by one member of a consolidated group to another member as an intercompany transaction[623] and provide that an intercompany distribution is excluded from the gross income of the distributee member to the extent there is a corresponding negative basis adjustment. The change to "excluding" intercompany dividends from gross income instead of "eliminating" them is not intended to be substantive. The preamble to the proposed regulations stated, "Excluding intercompany dividends from gross income is intended to have the same effect as eliminating them under the current regulations, but it conforms to the terminology generally used under the Code."[624]

An intercompany distribution is treated as occurring when the shareholding member becomes entitled to it (generally, on the record date) or, if earlier, when it is taken into account under the Code.[625] For example, if the distributee member becomes entitled to a cash distribution before it is made, the distribution is treated as made when such member becomes entitled to it.[626] To the extent an anticipated distribution is not made, appropriate adjustments must be made as of the date it was taken into account.[627] If nonmembers own stock of the distributing corporation at the time the distribution is treated as occurring under the entitlement rule, appropriate adjustments must be made to prevent the acceleration of distributions to members from affecting distributions to nonmembers.[628]

B. Tax Consequences to Distributing Corporation

The regulations governing intercompany transactions provide a "matching rule" and an "acceleration rule." Under the matching rule, the separate entity attributes of the selling member, S (i.e., the member transferring property), with respect to the intercompany distribution and the corresponding items of the buying member, B (i.e., the member receiving the property), generally are redetermined to the extent necessary to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation.[629] The acceleration rule, on the other hand, requires immediate recognition of S's intercompany items and B's corresponding items to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation.[630]

A §301 distribution of appreciated property is thus treated as an intercompany sale between members of a consolidated group. The matching and acceleration rules apply to the distributing member's (S's) gain or loss under §311(b) to defer the recognition of gain on the intercompany distributions of property.[631] Unlike a corporation filing a separate return, a consolidated member may realize, and later recognize, a loss from an intercompany distribution of depreciated property. S's loss is taken into account under the matching rule if the property subsequently is sold outside the consolidated group to a nonmember. The recognition of loss from distributions outside the group only applies when it was from an intercompany distribution given that §311(a) continues to apply to distributions to nonmembers.[632] In effect, a group is treated as a single entity with respect to the nonrecognition of loss under §311 on distributions to nonmembers.

C. Tax Consequences to Distributee Corporation

The consolidated return regulations state, "An intercompany distribution is not included in the gross income of the distributee member."[633] This exclusion applies, however, only to the extent the distributee member (B) makes a corresponding negative basis adjustment (equal to the full value of the distribution) to its S stock pursuant to Reg. §1.1502-32.[634] If the adjustment exceeds B's basis in the S stock, an excess loss account is created with respect to the stock basis.[635] For a detailed discussion regarding basis adjustments within the consolidated return context, see 755 T.M., *Consolidated Returns — Investment in Subsidiaries.*

D. Adjustment to Stock Basis

Distributions with respect to S's stock to which §301 applies (dividends) and all other distributions treated as dividends reduce P's basis in the S stock.[636] Alternatively, if the shares are redeemed, the basis is shifted to member shares held by other shareholder members.[637]

E. Combination of Two Consolidated Groups

The determination of the amount of available E&P to measure a dividend when two consolidated groups combine de-

[622] For a detailed description of the requirements for filing a consolidated federal income tax return, see 754 T.M., *Consolidated Returns — Elections and Filing.*

[623] Reg. §1.1502-13(b)(1)(i)(D).

[624] Preamble to CO-11-91, 59 Fed. Reg. 18,011 (Apr. 15, 1994).

[625] Reg. §1.1502-13(f)(2)(iv).

[626] *See* Reg. §1.1502-13(f)(7)(i)(E), as amended by T.D. 10018, 89 Fed. Reg. 106,848 (Dec. 30, 2024).

[627] Reg. §1.1502-13(f)(2)(iv)(A).

[628] Reg. §1.1502-13(f)(2)(iv)(B).

[629] Reg. §1.1502-13(c).

[630] Reg. §1.1502-13(d).

[631] Reg. §1.1502-13(f)(2)(iii); *see* Reg. §1.1502-13(f)(7)(i)(C), as amended by T.D. 10018, 89 Fed. Reg. 106,848 (Dec. 30, 2024).

[632] Reg. §1.1502-13(f)(2)(iii); *see* Reg. §1.1502-13(f)(7)(i)(D), as amended by T.D. 10018, 89 Fed. Reg. 106,848 (Dec. 30, 2024); PLR 200921002 (parent proposed controlled subsidiary pay a special dividend to parent and controlled common shareholder financed by external bridge loans; special dividend parent received was an intercompany distribution under Reg. §1.1502-13(f)(2) and special dividend public shareholders received was governed by §301).

[633] Reg. §1.1502-13(f)(2)(ii).

[634] Reg. §1.1502-13(f)(2)(ii).

[635] Reg. §1.1502-32(a)(3)(ii).

[636] Reg. §1.1502-32(b)(3)(v).

[637] Rev. Rul. 66-37.

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pends on the manner in which the groups combined. When one consolidated group acquires another consolidated group, the E&P remains with each of the consolidated groups with the members of one group joining the other consolidated group. The taxable year of each member of the acquired consolidated group ending at the end of the day they cease to be members of the old consolidated group.

One situation that may offer more complexities is when the groups are combined but are governed under the reverse acquisition rules of Reg. §1.1502-75(d)(3). In general, a reverse acquisition occurs when a large corporate group or corporation is taken over, in form, by a member of a smaller corporate group or corporation, but the stockholders of the larger group obtain a controlling interest in the smaller acquiring group as a result of the transaction.[638] More specifically, a reverse acquisition typically occurs when the shareholders of an acquired corporation receive more than 50 percent of the fair market value of the stock of an acquiring company in exchange (in whole or in part) for either (1) an interest in the shares of the acquired corporation that would cause it to become a member of an affiliated group with the acquiring corporation or (2) substantially all of the assets of the acquired corporation. The impact of a reverse acquisition is that the acquired group continues or becomes the parent of the group that was the acquirer with the acquiring group terminating. A reverse acquisition is also considered a group structure change which requires the new parent to include the old parent's E&P at the date of the combination.[639] As a result, the smaller acquiring company is thus prevented from making a tax-free distribution to the shareholders when the dividend's E&P should be sourced from the acquired subsidiary, which is the parent of the group for consolidated return purposes.[640]

[638] A "controlling interest" is represented by more than 50 percent of the value of the stock of the smaller group's parent.

[639] *See* Reg. §1.1502-33(f)(1)(i). If P succeeds another corporation under the principles of Reg. §1.1502-75(d)(2) or §1.1502-75(d)(3) as the common parent of a consolidated group (a group structure change), the earnings and profits of P are adjusted immediately after P becomes the new common parent to reflect the earnings and profits of the former common parent immediately before the former common parent ceases to be the common parent. The adjustment is made as if P succeeds to the earnings and profits of the former common parent in a transaction described in §381(a).

[640] *See* Sheffield, Jeffrey, *Whose Earnings and Profits? What Dividend? A Discussion Based on the Dr. Pepper — Keurig Transaction*, 73 Tax Lawyer 299 (2020).

F. Examples

The following examples illustrate the tax rules concerning dividends from one member of an affiliated group to another.

> *Example 1 — Dividend Exclusion And Property Distribution:* S owns land with a $70 basis and a $100 value. On January 1, Year One, P's basis in S's stock is $100. During Year One, S declares and makes a dividend distribution of the land to P. Under §311(b), S has a $30 gain. Under §301(d), P's basis in the land is $100. On July 1, Year Five, P sells the land to X (an unrelated party) for $110.
>
> Under Reg. §1.1502-13(b)(1), S's distribution to P is an intercompany distribution. Under Reg. §1.1502-13(f)(2)(ii), P's $100 of dividend income is not included in gross income. Under Reg. §1.1502-32, P's basis in S's stock is reduced from $100 to $0 in Year One.
>
> Under the matching rule (treating P as the buying member and S as the selling member), S takes its $30 gain into account in Year Five to reflect the $30 difference between P's $10 gain taken into account and the $40 recomputed gain. Under Reg. §1.1502-32, P's basis in S's stock is increased from $0 to $30 in Year Five.[641]

> *Example 2 — Loss Property:* The facts are the same as in the prior example except that S has a $130 (rather than $70) basis in the land. Under Reg. §1.1502-13(f)(2)(iii), the principles of §311(b) apply to S's loss from the intercompany distribution. Thus, S has a $30 loss that is taken into account under the matching rule in Year Five to reflect the $30 difference between P's $10 gain taken into account and the $20 recomputed loss. Under Reg. §1.1502-32, P's basis in S's stock is reduced from $100 to $0 in Year One, and from $0 to a $30 excess loss account in Year Five. (If P had distributed the land to its shareholders, rather than selling the land to X, P would take its $10 gain under §311(b) into account, and S would take its $30 loss into account under the matching rule with $10 offset by P's gain and $20 recharacterized as a noncapital, nondeductible amount.).[642]

[641] *See* Reg. §1.1502-13(f)(7)(i) *Ex.* 1, as amended by T.D. 10018, 89 Fed. Reg. 106,848 (Dec. 30, 2024).

[642] Reg. §1.1502-13(f)(7)(i)(D), as amended by T.D. 10018, 89 Fed. Reg. 106,848 (Dec. 30, 2024).

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X. Dividends Related to Stock Sales

A. General

Traditionally, individual and corporate sellers approached the issues discussed herein from different directions. The reason for their differences emanated from the dissimilar tax treatment of individuals and corporations. Generally, corporations recognize little, if any, income on the receipt of dividends because of the DRD, discussed above. In contrast, capital gains realized by corporations are generally taxable at the applicable corporate tax rate. Individuals, however, may enjoy a capital gain preference.[643] Before the 2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA),[644] though, individuals recognized all dividend income as ordinary income. With the enactment of the 2003 JGTRRA, individuals' preferences between receiving qualified dividends and receiving capital gain treatment have lessened considerably.

Given their previously dissimilar tax situations, it was fairly safe to generalize about tax strategies for individual and corporate sellers. When considering a sale of a stock investment, an individual seller traditionally sought to realize the entire value of the investment as sales proceeds to generate a capital gain. Following the 2003 JGTRRA, however, the tax difference to the individual seller between a sale and a dividend may not be as great. Conversely, a corporate seller probably wants part of the value of the stock investment realized as a dividend, to obtain the dividends received deduction (DRD).

> *Example:* A shareholder (S) decides to sell stock in a corporation (T) to a purchaser (P). Under ordinary tax principles, S would recognize gain or loss depending upon S's basis in the stock of T and the consideration received. S sells stock of T that has a basis of $70 and a fair market value of $100. T has earnings and profits of $30. If S is a corporation, it normally will prefer to receive as much as possible of its appreciation in T as a dividend because its tax rate on capital gains is substantially higher than its effective rate on dividends after the DRD. Assuming a 21% tax rate,[645] if corporation S had sold the stock of T for $100, its gain of $30 would produce a tax of $6.30. If, on the other hand, S had received a $70 purchase price (and thus no gain) and, before the sale, $30 as a dividend, its tax cost would be no greater than $3.15 (i.e., 21% tax rate with a 50% DRD).[646]

Comment: Corporation S may suggest the pre-sale dividend as a method of reducing its tax rate through the DRD. A pre-sale dividend may be suggested by P for the purpose of ridding T of unwanted assets or reducing the purchase price. Suppose in the example above that T has $30 worth of government bonds that are not needed in its operation. P may prefer to have those bonds removed from T so that it does not have to buy them. It is important to note that, regardless of the form chosen by the taxpayers, the IRS may attempt to recharacterize the dividend as part of the purchase transaction, as discussed below.

1. Effect on Purchaser

If the pre-sale dividend is treated as a part of the purchase price, P is substantially affected. Using the example, assume that T makes a $30 distribution to S just before the sale of the T stock to P. In such a case, P pays only $70 for T, because the value of T was reduced by the amount of the distribution to S. Based on form, P has a basis in T of $70. If the transaction is recast by the IRS so that the $30 "dividend" is treated as part of the purchase price, then P is treated as having purchased the stock of T for $100, paying $70 at the closing and receiving a $30 dividend from T that is deemed to have been delivered to S. Under the recast transaction, P has a dividend of $30 and a basis in the T stock of $100. T is worth only $70. Assuming that P does not file a consolidated return with T and that §1059 is not applicable, P's income from the dividend is offset by a corresponding loss when it sells the T stock for $70 with a basis of $100. Generally speaking, this is not a favorable result for P, because, if for no other reason, P prefers not to pay taxes now and get a corresponding tax benefit later (i.e., higher basis).

2. Effect on Individual Seller

If S is an individual, S may argue (depending on the rates at which the pre-sale dividend would be taxed to S) that a pre-sale dividend is in fact part of the purchase price, to generate a capital gain. The government, however, may argue that the dividend should be respected as such.

3. Effect on Corporate Seller

If S is a corporation, the government may argue that the pre-sale dividend is a part of the purchase price, thus denying corporate S the benefit of the DRD.

B. Judicial and Administrative Authorities — Shareholder Is an Individual

Typically, if S is an individual, the issues of a presale dividend are raised when S claims that a distribution designated as a dividend was part of the purchase price. The following is a discussion of how the courts have responded to attempts to recharacterize a pre-sale dividend as part of the purchase price.

1. Who Is the Beneficial Owner of the Stock?

To some extent, a determination of whether S is to be treated as the recipient of the dividend or whether the distribution is considered part of the purchase price depends upon a conclusion as to who is the beneficial owner of the T stock. A starting place for such a determination is the §61 regulations, which state: "When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller."[647]

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[643] For a discussion of capital gain income and tax rates, see 561 T.M., *Capital Assets*.

[644] Pub. L. No. 108-27.

[645] For taxable years beginning after December 31, 2017, the TCJA provides for a flat 21% corporate tax rate. §11(b). Prior to the effective date of the TCJA, the highest corporate rate was 35%.

[646] For taxable years beginning before January 1, 2018, the applicable DRD percentage would have been 70%. However, for taxable years beginning after December 31, 2017, the TCJA reduced the 70% DRD to 50% (and reduced the 80% DRD to 65%). *See* §243.

[647] Reg. §1.61-9(c).

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This statement is deceptively simple; contractual provisions often affect who is the economic owner of the stock, even when stock certificates have not actually been delivered to the purchaser. Additionally, there may be situations in which the seller retains title to stock for the purpose of securing payments to be made to it by P. In such a case, dividends are charged to P even though paid directly to the seller as a part of the purchase price.[648]

Two early Tax Court cases apply a form of the beneficial ownership rule. In *Coffey v. Commissioner*,[649] an individual shareholder (S) received a distribution of a contingent right from T. The distribution of the contingent right was permitted by the agreement between P and S because the parties could not value the right and P did not wish to acquire it when it bought the stock of T. Before the delivery by S of the T stock to P, T's board of directors met and voted to distribute the contingent right to S. Because S was an individual, he preferred to ignore the form of the transaction (i.e., a dividend) and treated the distribution as a part of the purchase price (thus receiving the then favorable capital gain rate). The IRS argued that the transaction was what the form indicated, a dividend. The Tax Court noted that it was significant that S did not transfer his stock to P until a resolution was passed by T's board of directors assuring S of the receipt of the contingent right. The Tax Court concluded that the distribution was a dividend and not part of the purchase price. The Tax Court distinguished *Ball v. Commissioner*,[650] in which the distribution was authorized after the transfer of the stock.

In *Gilmore v. Commissioner*,[651] the fact that the actual distribution did not occur until after the stock of T had been transferred to P did not prevent the Tax Court from finding a dividend. In this case, S argued that no dividend was distributed because he had contracted with P to increase the purchase price by the value of the items to be distributed and he had caused them to be distributed to P, who would then pay them over to S. Presumably, this would have produced the capital gain treatment S desired. The court rejected this argument, determining that no such agreement existed.[652]

Coffey and *Gilmore* dealt with situations in which the purchase price was set in contemplation of S's causing T to distribute the assets that were the subject of the dividend. The analysis becomes more difficult when the purchase price to be paid by P is based upon a formula. For example, P may agree to pay book value for the stock of T. In such a case, S can choose whether to cause T to declare a dividend at any time up to closing without affecting the amount of the proceeds; if T declares the dividend its value and thus the amount paid by P go down correspondingly, but if S does not cause T to declare the dividend T's value remains unimpaired and P must pay a greater amount. A formula contract, as opposed to one in which the distributed asset is excluded and its distribution provided for, may more easily result in classification of the "dividend" as part of the purchase price.

In *Wilson v. Commissioner*,[653] S argued in what appeared to be a formula pattern that the "dividend" should be treated as part of the purchase price. S maintained that the distribution "only served to reduce the consideration which [P] had previously agreed to pay for the stock … ." The Tax Court rejected S's argument because the distribution had taken place before the date on which the value of the corporation was determined. In essence, the Tax Court found the case to be like *Coffey* and *Gilmore* because the distribution did not directly affect the price to be paid. Although it is not clear, presumably the Tax Court would have found the distribution to be part of the purchase price if it had occurred after the time when the price was fixed and subject to reduction for later distributions, i.e., a formula contract.

A different perspective on this issue relates to the taxation of P in these transactions. If the distribution is treated as part of the purchase price, then T must have paid a dividend to P, which in turn paid it over to S. In *Wilson*, the Tax Court found that the distribution to S was a dividend and, as a consequence, found that no dividend payment was made to P. According to the court, P was not the beneficial owner of T at the time the dividend was declared.

Yet another approach relates to P's obligation. If P had an irrevocable obligation to S and part of that obligation is met by a distribution of assets owned by T, then it may be reasonable to charge P with the income.[654] In *Wilson*, the Tax Court found that the distribution occurred before any irrevocable obligation on the part of P was fixed, and, therefore, the distribution was not charged as a dividend to P.

In TAM 9003003, however, the National Office concluded that the distribution occurred after P had acquired a primary and unconditional obligation to acquire T. Accordingly, the National Office advised that T's distribution to P of a sum equal to the purchase price, which P then transferred to S in exchange for all of S's shares, was a dividend as to P. The National Office based its ruling on *Sullivan v. United States*,[655] in which the Eighth Circuit held that S, the majority stockholder in P, received a constructive dividend when P satisfied S's unconditional obligation to purchase the only other stockholder's shares by redeeming them. The National Office observed, however, that P could have avoided characterization of the payment as a dividend if he had demonstrated that he was acting as an agent for T in a transaction resulting in, for example, a redemption of T's stock. The National Office cautioned that the redemption must be actual, not merely constructive.

P is perhaps in greatest danger of having dividend income attributed to P when P is already a shareholder in T at the time that P contracts to acquire S's stock in T. In *Buchholz Mortuaries, Inc. v. Commissioner*,[656] for example, T, not P, acquired S's stock in a redemption, which occurred after P and S con-

[648] Reg. §1.61-9(c). *See also DeGuire v. Higgins*, 159 F.2d 921 (2d Cir. 1947).

[649] 14 T.C. 1410 (1950).

[650] 27 B.T.A. 388 (1932), *aff'd on other issues sub nom.*, *Von Weise v. Commissioner*, 69 F.2d 439 (8th Cir. 1934).

[651] 25 T.C. 1321 (1956). *See also Reitz v. Commissioner*, 61 T.C. 443 (1974).

[652] Another reason for rejecting this type of argument is that it may affect the tax treatment of P, i.e., P receives the dividend and has the appropriate tax results, including income and a higher basis. This approach is somewhat formalistic and seems to let the parties reach the result they desire through the form in which they cast the transaction.

[653] 27 T.C. 976 (1957).

[654] *See, e.g., Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966).

[655] 363 F.2d 724 (8th Cir. 1966).

[656] T.C. Memo 1990-269.

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tracted to have P acquire all of S's stock. The Tax Court, stating that whether dividend income is attributed to P depends on whether P has incurred "a primary and unconditional obligation" to acquire such stock, determined that P had not acquired such an obligation because it had contracted that P "or his assigns" would acquire the stock and P, therefore, had the option of having T acquire S's stock.

2. Integrated Plan

The Tax Court's decision in *Steel Improvement & Forge Co. v. Commissioner*[657] is consistent with the rules described above. In that case, a corporate shareholder (S) contracted to sell the stock of wholly owned T. The agreement provided that T would not distribute more than $180,000 as a dividend. The purchase price would be adjusted upward if T did not declare a dividend, but that adjustment could not exceed $64,000. In other words, S could cause T to distribute $180,000 or, if T did not make any distribution to S, the purchase price would be increased by $64,000. Obviously, S would cause T to distribute a dividend of at least $116,000 (i.e., the difference between the permitted dividend and the maximum adjustment to the purchase price).

The dividend was paid before the formal transfer of the stock. The resolution authorizing the dividend was passed by a board comprised of S representatives but was not declared or paid until after the contract for sale was fully effective, i.e., at a time when beneficial ownership had passed to P. The Tax Court treated the $116,000 distribution as a dividend to S even though it occurred after beneficial ownership had passed to P, because it was substantially equivalent to a pre-beneficial change of ownership dividend. The Tax Court stated:

> [T]he agreed purchase price was not to be altered whether or not the dividend to the extent of $116,000 was paid. Here, if [S] were to receive the $116,000 at all, it was necessary for it to take the amount as a dividend. This arrangement was an integral part of the original contract of sale negotiated between the parties.[658]

The payment of the $116,000 dividend by T or S did not affect the obligation of P.[659]

The dissent in *Steel Improvement* concluded that the $116,000 distribution should be treated as part of the purchase price because P was the beneficial owner of T at the time of the declaration even though S's directors remained in control of the corporation. The contract provided that control was subject to the terms and conditions of the purchase agreement; S's representatives were trustees for P managing the property for P's benefit. The dissent also noted:

> It is less than realistic to suppose that the amount agreed to be paid as purchase price under this arrangement was not lessened because [S] took the designated surplus or conversely, that [P] would not have paid more if [S] had not done so. Thus the disputed dividend in the instant case affected the quantum of the purchase price to be paid … .[660]

If not for the dissent in *Steel Improvement*, one might conclude that a dividend to S before a sale will be respected and treated as such for the tax purposes of both S and P if: (1) at the time of the declaration and record date of the dividend, S is (at least nominally) in control of T; and (2) assuming the dividend is not directly tied to the sale agreement, the agreement permits the dividend but the distribution of the dividend does not affect P's obligation to purchase the stock.

On appeal,[661] *Steel Improvement* was reversed by the Sixth Circuit, which found that P had beneficial ownership of T at the time of the declaration and that the negotiations showed that the $116,000 was "part of the purchase price." The Sixth Circuit seemed to deny the fiction that a permitted dividend not affecting the price is not part of the price.

In *Casner v. Commissioner*,[662] the Fifth Circuit reviewed a decision of the Tax Court that had stated that presale distributions were dividends. The dividends were declared on March 26 and 27, but the date for determining book values for purposes of computing the purchase price was not until March 31. Additionally, the Tax Court found that the beneficial ownership of the stock of the distributing corporations remained with S when the dividends were declared. The Fifth Circuit reversed the Tax Court and concluded that these distributions were paid to S as part of the purchase price. The court stated:

> Thus, looking through the form of the transaction to its economic substance, we are of the view that the cash distributions to the selling stockholders were not essentially equivalent to the distribution of a taxable dividend to them. We are convinced that such cash distributions to the selling stockholders constituted in fact, and in accordance with the pre-conceived multi-step plan, a part of the purchase price to be paid to the selling stockholders for their stockholdings.[663]

After *Casner*, it was not clear whether S could rely on the form of the presale dividend distributions and treat them as dividends (as in *Coffey*), or whether the courts would look through and determine that the pre-sale dividend distributions were in fact part of the purchase price.

3. Rev. Rul. 75-493

Rev. Rul. 75-493 involved facts similar to those in *Casner*. S was an individual who owned all of the stock of T. S was involved in negotiations with P for P to purchase all of T's stock. P did not want cash held by T. Consequently, S caused T to declare and pay a dividend of the unwanted cash. At the time of the distribution, P was under no legal obligation to purchase S's T stock. On the day after the distribution, S and P entered into an agreement for the sale of the T stock for a fixed dollar amount. The IRS noted that the payment of the dividend did not reduce P's obligation to pay the agreed price. Under a *Casner*-type approach, it should be clear that the parties intended

[657] 36 T.C. 265 (1961).

[658] 36 T.C. at 274.

[659] *See* Steines, *Taxation of Corporate Distributions — Before and After TEFRA*, 68 Iowa L. Rev. 937 (1983).

[660] 36 T.C. at 283.

[661] 314 F.2d 96 (6th Cir. 1963).

[662] 450 F.2d 379 (5th Cir. 1971), *aff'g in part and rev'g in part* T.C. Memo 1969-98.

[663] 450 F.2d at 397.

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that the amounts of the distribution would, in fact, reduce the price. Notwithstanding this, the IRS ruled that the distribution "cannot be considered a part of the purchase price paid by P to S." Because the IRS concluded that no payment had been made on behalf of P's obligation, there was no dividend from T to P.

Rev. Rul. 75-493 indicates that, at least in the case of an individual S, a dividend declared before a transaction is treated as a dividend and not part of the purchase price.[664]

4. Conclusion

Purchasers in P's position, especially if they are individuals, should be aware that they can be charged with the dividend in an acquisition if T makes a distribution to S as a part of the transfer transaction. In such situations, P should fashion the transaction to conform as closely as possible to the facts in Rev. Rul. 75-493.

C. Judicial and Administrative Authorities — Shareholder Is a Corporation

If S is a corporation, it generally will attempt to convert as much as possible of the purchase price for stock owned by it to dividends, to obtain the benefit of the dividends received deduction.

1. Who Is the Beneficial Owner of the Stock?

Courts sometimes have looked to determine the beneficial owner of a corporation's stock at the time a dividend was declared in deciding who should be charged with the dividend.[665] Although these cases relate to situations involving an individual S, they should be applicable to a corporate S as well. Some of these decisions are formalistic, treating the distribution as a dividend when S was the beneficial owner at the time of the declaration, while others look to the substance of the transaction.[666]

The Fifth Circuit supported the formalistic approach in *TSN Liquidating Corp. v. United States*.[667] That case involved a corporate S that owned 90% of an insurance corporation T. P wanted to purchase T, but wanted it first to distribute a substantial portion of its investment portfolio to S because P found the portfolio unsuitable for an insurance company. Immediately after P acquired T, P provided T with a new portfolio for its insurance reserves comprised of bonds and more conservative investments. The district court concluded that there was no business purpose for the dividend and that it was "part and parcel" of the purchase agreement with P.[668] As a consequence, the district court held that the dividend would be taxed to corporate S as the proceeds from the sale of T, rather than as a dividend of T for which S could benefit from the DRD.

On appeal, S argued that the cases relied upon by the district court were exceptions to the general rule. The general rule asserted is that assets removed from a corporation by a dividend made in contemplation of a sale of the stock by that corporation, when the assets are in good faith to be retained by the selling shareholder and not thereafter transferred to the buyer, are taxable as a dividend and not as part of the price paid for the stock because, in economic reality and in substance, the selling shareholders did not sell and the buyer did not purchase or pay for the excluded assets. The cases cited for this proposition were *Gilmore v. Commissioner*[669] and *Coffey v. Commissioner*.[670] The Fifth Circuit agreed with S, distinguishing the case from *Waterman S.S. Corp. v. Commissioner*,[671] in which the distribution of assets was designed solely to achieve a tax-free distribution. The Fifth Circuit concluded that there was no evidence of any tax-avoidance scheme on the part of S.

2. Integrated Plan

The courts in *Steel Improvement* and *Casner*[672] looked at whether the distribution was an integral part of the plan for the sale of T. If it was, they treated the distributions as part of the purchase price. Notwithstanding these cases, Rev. Rul. 75-493[673] permits the distribution, at least for individuals, to be treated as a dividend and not part of the purchase price. The ruling requires that P not have entered into a binding contract to purchase T at the time of the distribution. It is not clear what effect Rev. Rul. 75-493 has on transactions if S is a corporation. If applied, the ruling would permit a corporate S to strip out the earnings and profits of T without applying the integrated plan cases.[674]

3. Sham

An exception to the general rule as stated in Rev. Rul. 75-493 and *TSN Liquidating*[675] is transactions classified as shams. The leading case in this area is *Waterman S.S. Corp. v. Commissioner*.[676] Waterman Steamship was a corporation that owned all the shares of two subsidiaries. A purchaser offered to buy the stock of the two subsidiaries for $3,500,000. Waterman's basis in the stock of the subsidiaries was $700,000, which would have produced a gain of approximately $2.8 million. Waterman declined the offer and proposed to sell the stock of the two subsidiaries to the purchaser for approximately $700,000 after it had declared a dividend of $2.8 million to itself. Because Waterman filed a consolidated return with the two subsidiaries, the dividend would have been eliminated. It was not intended that any of the subsidiaries' assets be removed in conjunction with the sale. To effect the dividend, Waterman caused the subsidiaries to declare a dividend and issue their note for that amount. After the acquisition by P, money

[664] *But see Basic Inc. v. United States*, 549 F.2d 740 (Ct. Cl. 1977) (Court of Claims indicated its doubt of correctness of Rev. Rul. 75-493, at least when distributed asset is sold). *See also* PLR 200752014 (IRS treated a post-merger distribution separate from the merger).

[665] See X.B.1., above.

[666] *See, e.g., Casner v. Commissioner*, 450 F.2d 379 (5th Cir. 1971); *Coffey v. Commissioner*, 14 T.C. 1410 (1950).

[667] 624 F.2d 1328 (5th Cir. 1980). *See also Uniroyal Inc. & Consol. Subsidiaries v. Commissioner*, T.C. Memo 1993-214 (pre-sale transfer of cash not part of sales price; dividend found).

[668] *TSN Liquidating Corp., Inc. v. United States*, 77-2 USTC ¶9741 (N.D. Tex. 1977). *See also* FSA 200238032 (most important factor in determining if "dividend" should be characterized as part of consideration paid for stock is whether purchaser truly did not want distributed assets).

[669] 25 T.C. 1321 (1956).

[670] 14 T.C. 1410 (1950). See X.B.1., above.

[671] 430 F.2d 1185 (5th Cir. 1970). For further discussion, see X.C.3., below.

[672] See X.B.1. and X.B.2., above.

[673] For further discussion, see X.B.3., above.

[674] The IRS apparently applied the concept of Rev. Rul. 75-493 in TAM 8118004.

[675] See X.C.1. and X.C.2., above.

[676] 430 F.2d 1185 (5th Cir. 1970).

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was contributed or loaned to the subsidiaries, enabling the subsidiaries to pay the note. The Fifth Circuit, reversing the decision of the Tax Court, concluded that there had been no dividend, but, rather, that the transaction was set up as a conduit for the payment of the purchase price to Waterman. The Fifth Circuit cited decisions on the question of legal and beneficial ownership of the stock at the time of the dividend, as described above, and stated:

> Those cases were concerned with corporate distributions which were concededly dividends; the only issue was determining whether the seller or the buyer of the stock was to be deemed the recipient of the dividend. Nor is the lack of a binding agreement affirmatively demonstrating that Waterman was the beneficial owner of the stock when the dividend was declared dispositive of the issue … . The Tax Court's conclusion that Waterman was in substance both the legal and beneficial owner of the stock when the dividend was declared does not answer the question whether in substance a dividend was declared.[677]

The outcome in *Litton Indus., Inc. v. Commissioner*[678] was different from that in *Waterman*. Litton owned all the stock of Stouffer Corporation. Stouffer paid a dividend of $30 million by distributing a note to Litton. Seven months later, Nestle offered to buy Stouffer for $105 million. Ultimately, Nestle bought all the Stouffer stock for $75 million and paid Litton $30 million for the note. The Tax Court held that the note was a dividend and not a part of the purchase price. The court distinguished *Waterman* because the note in this case was distributed before Litton made public the fact that Stouffer was for sale. The court also noted that Stouffer had more than $30 million of earnings and profits at the time of the distribution.

Note: Although the IRS acquiesced in the result reached in *Litton*, it indicated that it disagrees with some or all of the reasons given by the Tax Court for the decision.[679]

[677] 430 F.2d at 1195.
[678] 89 T.C. 1086 (1987).
[679] 1988-2 C.B. 1.

4. Conclusion

The use of pre-sale dividends when S is a corporation offers much greater opportunity for tax avoidance than when S is an individual. However, the cases and rulings seem to apply interchangeably. One might expect that a pre-sale dividend to a corporate S along the lines of Rev. Rul. 75-493 would be respected, at least when S retains the distributed assets and tax avoidance is not as obvious as in *Waterman*.

5. Consolidated Return Regulations

At the time of the *Waterman* transaction, a distribution by a consolidated subsidiary did not affect the parent's basis in the subsidiary's stock. Consequently, the distribution was tax-free and the stock could be sold for its historic basis.

Now, however, dividend distributions with respect to a subsidiary's stock reduce the parent corporation's basis in the subsidiary stock.[680] Consequently, even though the dividend is tax-free, it reduces basis and thus increases gain and produces no net favorable result for the taxpayer. Therefore, the pre-sale dividend technique of lowering S's corporate tax rate is usually effective only if S and T do not file consolidated tax returns.

D. Distributions as Part of Plan of Reorganization or Tax-Free Spinoff

A group of corporations may have distributions that are part of an integrated plan of reorganization or other tax-free transactions. Distributions that are part of a plan are generally not tested as dividends under §301. The Tax Court held that §356 is "the exclusive measure of dividend income provided by Congress where cash is distributed to shareholders as an incident to a reorganization."[681] These distributions were tested as boot under the reorganization rules as opposed to §301. In Rev. Rul. 2017-9, the IRS concluded that a transfer of money and other property in pursuance of a plan of reorganization properly is treated as 'boot' subject to gain recognition under §361 in a distribution by a controlled corporation to the distribution corporation occurring in connection with a divisive reorganization under §368(a)(1)(D) and §355.

[680] Reg. §1.1502-32(b)(2)(iv), §1.1502-32(b)(3)(v).
[681] *Estates of Bell v. Commissioner*, T.C. Memo 1971-285.

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XI. Reporting and Withholding

A. *Reporting Requirements*

A corporation that pays dividends aggregating $10 or more to any person during a calendar year must file information returns on Form 1099-DIV with the IRS after September 30 of that year, but not before the corporation's final distribution for the year, and on or before February 28 (March 31 if filed electronically) of the following year.[682] The corporation also must furnish statements (Form 1099-DIV) to the payees, either in person or by first class mail, on or before January 31 of the following year.[683] If the corporation fails to file a correct information return with the IRS or furnish correct statements to the payees, the penalty generally is $50 for each return or statement required to be filed before January 1, 2011. For each return or statement required to be filed on or after January 1, 2011, the penalty generally is $100.[684] For each return or statement required to be filed on or after January 1, 2016, the penalty generally is $250 (annually adjusted for inflation).[685]

For purposes of the reporting requirements, a dividend is any distribution by a corporation that is a "dividend" within the meaning of §316[686] and any payment made by a stockbroker to any person as a substitute for a dividend.[687]

If a corporation makes a nontaxable distribution to its shareholders, it must file Form 5452, *Corporate Report of Nondividend Distributions*, with the IRS. A calendar tax year corporation must file Form 5452 with its income tax return for the year in which the nondividend distributions were made. A fiscal year corporation must file Form 5452 with its income tax return for the first fiscal year ending after the calendar year in which the nondividend distributions were made.[688]

Additionally, a corporation that makes a distribution in excess is required to file Form 8937, *Report of Organizational Actions Affecting Basis of Securities*. Taxpayers that are required to file Form 8937 also are required to provide a copy of the form (or a written statement containing the same information) to each security holder of record as of the date of the organizational action and to all subsequent holders of record up to the date that the copy of the Form 8937 is provided. A taxpayer alternatively may post "required information," rather than Form 8937 itself, on its web site.[689] Such issuer statements generally are required to be provided on or before January 15 of the year following the calendar year of the organizational action.

B. *Backup Withholding Requirements*

Dividends are subject to backup withholding if an information return is required under §6042(a).[690] As discussed above, dividends subject to reporting generally include any distribution by a corporation to its shareholders that qualifies as a dividend under §316.

Section 3406(a) provides generally that any payor of reportable dividends must withhold a tax equal to the product of the fourth lowest rate of tax for single taxpayers under §1(c) and any payment to a nonexempt payee if any of the following conditions exists:

(1) the payee fails to furnish his tax identification number (TIN) to the payor in the manner required;

(2) the IRS notifies the payor that the TIN furnished by the payee is incorrect;

(3) the IRS notifies the payor that backup withholding is required because the payee failed to properly report interest, dividends, or patronage dividends in prior tax years; or

(4) the payee fails to certify, under penalties of perjury, that the payee is not subject to backup withholding when such certification is required.[691]

Certification by the payee that the payee is not subject to backup withholding applies only with respect to instruments acquired after 1983.[692] The certification rule requires a payee to certify to the payor, under penalties of perjury, that the payee is not subject to backup withholding due to underreporting of dividends or interest.[693] The payee also must certify that the TIN provided to the payor is the payee's correct number.[694] If the payee fails to make either of these certifications, or if after making the certifications the payor is notified by the IRS that the payee's TIN is incorrect or that backup withholding is required because of underreporting, the corporation must implement backup withholding with respect to that payee.[695]

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[682] §6042; Reg. §1.6042-2(c). The regulations allow corporations to obtain an automatic 30-day extension of time to file Form 1099-DIV with the IRS by submitting Form 8809, *Application for Extension of Time to File Information Returns*. Reg. §1.6081-8(a)(1), §1.6081-8(c)(1); T.D. 9838, 83 Fed. Reg. 38,023 (Aug. 3, 2018). A request for an automatic 30-day extension does not require a signature or explanation on the Form 8809. Reg. §1.6081-8(c)(1). A request for an additional 30-day extension may be made, but it requires a detailed explanation and signature. Reg. §1.6081-8(a)(2), §1.6081-8(c)(2); T.D. 9838.

[683] §6042(c). A request for an extension of time to provide payee statements to recipients is made using Form 15397, *Application for Extension of Time to Furnish Recipient Statements*.

[684] §6721, §6722. For further discussion of the §6721 and §6722 penalties, see 634 T.M., *Civil Tax Penalties*.

[685] §6721, §6722. For inflation-adjusted amounts, see Tables, Charts & Lists, *Failure to File Correct Information Returns §6721* and *Failure to Furnish Correct Payee Statements §6722*.

[686] §6042(b)(1)(A).

[687] §6042(b)(1)(B).

[688] *See* Instructions for Form 5452. The instructions state that additional materials must be submitted with Form 5452, such as a computation of the earnings and profits for the tax year and a tax-basis balance sheet if the corporation was required to complete Schedule L (Form 1120).

[689] *See* Instructions for Form 8937.

[690] §3406(b)(2)(A)(ii).

[691] Before its amendment by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, §101(c), §3406(a) provided simply that the tax was equal to 31%. The 2001 amendment was subject to the EGTRRA sunset provision, §901, which itself was amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 TRA), Pub. L. No. 111-312, §101(c), to state that the subject provisions — including the §3406(a) formula — did not apply to tax years beginning after December 31, 2012. The EGTRRA and 2010 TRA sunset provisions were later stricken by the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, §101, thus making the EGTRRA amendments permanent.

[692] §3406(d)(3).

[693] §3406(d)(1).

[694] §3406(e)(1).

[695] §3406(a)(1)(D), §3406(c)(1), §3406(e)(1), §3406(e)(2). See Rev. Proc. 2014-43 for procedures for payees to obtain validation of Social Security number to stop or prevent backup withholding.

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With respect to stock acquired before 1984, the corporation must implement backup withholding on dividends only if the payee fails to provide the payee's TIN to the corporation. Certification that the payee's TIN is correct or that the payee is not subject to withholding because of underreporting is not required (although, if the IRS thereafter notifies the payor that the payee's TIN is incorrect or that underreporting has occurred, backup withholding in the amount of 31% of the distribution is necessary).[696]

Regulations relating to backup withholding generally provide that a payment of a kind required to be reported under §6042 (relating to returns regarding payment of dividends and corporate earnings and profits), and to a payee to whom §6042 requires reporting, is a reportable payment for purposes of the backup withholding rules of §3406.[697]

If backup withholding is required, the payor must withhold at the time it makes the payment to the payee or to the payee's account.[698] Amounts are considered paid when they are credited, or made available to, the payee's account.[699] In the case of stock for which the record date is earlier than the payment date, the dividends are considered paid on the payment date.[700]

In a corporate reorganization, if a payee is required to exchange stock held in the former corporation for stock in the new corporation before the dividends that have been paid with respect to the stock in the new corporation are provided to the payee, the dividend is considered paid on the date on which the payee actually exchanges the stock and receives the dividend.[701]

Backup withholding generally does not apply to:

(1) any amount treated as a taxable dividend by reason of §302, §304, §306, §356, or former §1081(e)(2);

(2) any exempt-interest dividend paid by a regulated investment company; or

(3) any amount paid or treated as paid during a year by a regulated investment company, provided that the payor reasonably estimates that 95% or more of all dividends paid or treated as paid during the year are exempt-interest dividends.[702]

The amount of a dividend subject to backup withholding is the amount subject to reporting under §6042, including any dividend that is reinvested pursuant to a plan under which a shareholder may elect to receive stock as a dividend instead of property. Except as noted below, withholding applies to the entire amount of the distribution.[703]

If the payor is unable to determine the portion of a distribution that is a dividend, the entire amount of the distribution must be treated as a dividend for information reporting under §6042. Withholding, in that case, applies to the entire amount of the distribution. However, if a payor can reasonably estimate the portion of a distribution that is not a dividend, the payor cannot withhold on that portion (which is not considered a dividend). A payor making a payment all or a portion of which may not be a dividend may use previous experience to estimate the portion of a distribution that is not a dividend.[704]

If a dividend is paid pursuant to a dividend reinvestment plan, backup withholding applies at the time and to the amount made available to the shareholder or credited to the shareholder's account. At the discretion of the payor, withholding under §3406 need not be applied to any excess of the fair market value of the shares of stock received by the shareholder or credited to the shareholder's account over the purchase price of the shares (including shares acquired by the shareholder at a discount in connection with the dividend distribution) or to any fee that is paid by the payor in the nature of a broker's fee for purchase of the stock or service charge for maintenance of the shareholder's account. The payor must, however, treat any excess amounts and fees on a consistent basis for each calendar year.[705]

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[696] §3406(e)(1), before amendment by the Deficit Reduction Act of 1984, Pub. L. No. 98-369; §3406(d)(3).

[697] Reg. §31.3406(b)(2)-4(a). *See also* Reg. §31.3406(c)-1 for the backup withholding rules with respect to payee accounts in cases in which the IRS or a broker notifies a payor that the payee is subject to withholding because notified payee underreporting and the payor is required to identify that account.

[698] Reg. §31.3406(a)-4(a)(1).

[699] Reg. §31.3406(a)-4(a)(1).

[700] Reg. §31.3406(a)-4(a)(2)(i).

[701] Reg. §31.3406(a)-4(a)(2)(ii).

[702] Reg. §31.3406(b)(2)-4(b). The regulations have not been amended to reflect the repeal of §1081 through §1083 by the 2005 Gulf Opportunity Zone Act (2005 GOZA), Pub. L. No. 109-135, §402(a). The repeal does not apply to any transaction ordered in compliance with the 1935 Public Utility Holding Company Act before its repeal. *But see* Prop. Reg. §1.1441-2, REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), which may impose withholding obligations on constructive dividends under §305.

[703] Reg. §31.3406(b)(2)-4(c)(1).

[704] Reg. §31.3406(b)(2)-4(c)(2). The payor's estimate is considered reasonable if (i) it does not exceed the proportion of the distributions made by the payor during the most recent calendar year for which a Form 1099 was required to be filed that was not reported by the payor as a dividend and (ii) the payor has no reasonable basis to expect that the proportion of the distribution that is not a dividend will be substantially different for the current year.

[705] Reg. §31.3406(b)(2)-4(c)(3).

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