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The Taxibility of Dividends

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THE TAXABILITY OF DIVIDENDS

by

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PREFACE

It is the intent of this paper to provide the individual stockholder with a knowledge of the tax treatment given dividends that he may receive and to explain certain taxable transactions he might have with a corporation.

Dividends may take the form of cash, property, stock, and liquidating dividends. It is also possible for a stockholder to have transactions with a corporation that will be taxed as a dividend even though there has been no formal dividend declaration.

Every stockholder must be alert to recognize the peculiarities that apply in his particular case because he may find that he is not gaining full benefit from many of the federal income tax provisions. A stockholder may find himself innocently liable for taxable transactions that he did not recognize and failed to report on his tax return.

No attempt has been made in the scope of this paper to discuss corporate reorganizations. The author feels that it would be almost impossible to state the specific tax treatment of such reorganizations because each case will involve different applications of the tax law. However, a stockholder should realize that a reorganization may result in taxable income to him and should try to consider the effects of these regulations before attempting to promote such a reorganization. Of course, a minority stockholder would be unable to control a reorganization. In such cases, however, it is up to him to determine his taxable position as it exists.

Chapter I of this paper will attempt to give the reader a general idea on how to recognize the various types of dividend declarations and how they are taxed. Chapter II and Chapter III deal mainly with transactions a stockholder has with a corporation that might result in a taxable dividend even though there has been no formal dividend declaration. It should be noted in this connection that because of the increasing complexity of our modern business units it is very difficult to enact tax regulations that will be applicable to every individual stockholder. Therefore, several tax cases will be quoted throughout this paper to help explain these transactions. The last chapter will be devoted to the author's recommendations and a study of miscellaneous tax provisions not covered in the first three chapters.

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CHAPTER I

FORMAL DIVIDEND DECLARATIONS

Dividends Defined

Enterprises have frequently been organized for the purpose of carrying on terminable ventures. In these cases the stockholder expects to have his capital returned as well as his share of the profits. In a large number of these enterprises, however, the viewpoint of a continuing business was adopted and capital was viewed as a permanent commitment with the expectation of payments confined to the distribution of earnings. Many stockholders think of dividends as representing the profits of a business and not a partial return of funds invested.

Writers have sometimes regarded dividends as shares distributed from a particular fund of assets, stating that it is the right of a stockholder to receive his profits from a special fund set apart from the general funds of the corporation. A more exact definition of a dividend may be stated as follows:

> A dividend is an appropriation of current or accumulated earnings with the intent to distribute an equivalent amount of enterprise assets among the stockholders of a particular class on a pro-rata basis.[1]

In identifying a dividend the <u>Accountants' Handbook</u> says:

> The act of appropriating earnings is more significant than the act of disbursing assets. Dividends are distributive shares in specific corporate funds only hypothetically; current earnings

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[1] W. A. Paton (ed.), <u>Accountants' Handbook</u> (New York: The Ronald Press Company, 1952), pp. 1039-40.

> cannot be strictly identified with specific assets, although the conceptual attachment may be an administrative aid.[2]

The term "dividend", as used for federal income tax purposes, means any distribution made by a corporation to its shareholders, whether in money or property,

> (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of the earnings and profits of the taxable year.[3]

Generally, such distributions are income to the shareholder and must be included in his gross income. There are, however, a number of statutory exceptions to this rule which will be discussed in the course of this paper.

Dividend Policy

The board of directors usually decides if the payment of a dividend is legal and if it is financially expedient to distribute. The payment or withholding of dividends is a matter of business policy over which the directors have complete jurisdiction. Since profits earned become the property of the corporation and not of the individual stockholders, the stockholders ordinarily have no legal right to demand any part of them.[4] There are only a few cases on record in which stockholders have forced the declaration of dividends on grounds other than fraud. Such a case arose in connection with the Ford Motor Company in 1916, when suit for more liberal dividends was brought by

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[2]Ibid.

[3]Federal Tax Course, 1957 (New Jersey: Prentice-Hall, Inc., 1956), p. 1701.

[4]Harry G. Guthmann and Herbert E. Dougall, Corporate Financial Policy (2d. ed.; New York: Prentice-Hall, Inc., 1948), pp. 465-66.

minority shareholders. At that time the company had a surplus of $112,000,000 and over $50,000,000 in cash on hand. Mr. Ford was determined to limit dividend payments to the current rate of sixty per cent on the company's capital stock of $2,000,000, so that the business might expand and employ more labor. The court held that it was the duty of the directors to administer the corporation for the benefit of the stockholders rather than for humanitarian purposes. They decided that an extra dividend of $19,000,000 should be declared and paid.[5]

The preceding comments have been aimed at giving the reader a general conception of what constitutes a dividend, who has the power to declare this dividend, and under what circumstances a corporation can legally be forced to pay a dividend. In order to discuss the tax treatment of dividends the foregoing discussion of the various types of dividends is necessary.

Types of Dividends

Cash dividends.--The most common type of dividend is the cash dividend. The declaration of a cash dividend creates a debt against the company and makes the stockholders general creditors for the amount of the dividend. Because stockholders receive dividends on the basis of the number of shares they own, the amount of dividends received by any stockholder will depend on the number of shares he holds. The corporation charter should clearly state the distinctions between the various classes of stock. If a cash dividend is declared by the board of directors and made public, it is usually irrevocable.[6]

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[5]Dodge v. Ford Motor Company, 204 Mich. 459 (1919).

[6]Guthmann and Dougall, p. 465.

Sometimes a stockholder has the election of receiving either a cash or stock dividend. In such a case he must make his decision within a certain period after receiving notice of the dividend. Even though stock dividends and stock rights would be otherwise exempt under the Sixteenth Amendment this type of dividend will be taxed as income to the stockholder.[7]

Scrip Dividends.--Dividends may be represented by issues of bonds, notes, or scrip. When earnings justify a dividend, but the cash position is temporarily weak, scrip dividends are used, although they are relatively rare as compared with cash and stock dividends. The scrip constitutes a current or fixed liability, depending upon maturity, of the company until it is paid. The use of scrip dividends is proper if the company has really earned a profit and merely has to wait for the conversion of other current assets into cash in the course of operations. In rare instances dividends are paid in bonds or notes that have long enough terms to fall outside of the current liability group. This effect is about the same as paying dividends in scrip except that the date of payment is postponed. Dividends in the above category are usually taxable unless they are a return of capital.[8]

Property dividends.--Property dividends involve payment with assets other than cash. Such a distribution may be made whenever there are assets that are no longer necessary in the operation of the business. These dividends are usually distributed in the form of securities owned and, very occasionally, property held as inventory. The fair market

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[7]Federal Tax Guide, 1957 (New York: Commerce Clearing House, Inc., 1956), p. 3424.

[8]Ibid., p. 2027.

value of the property as of the date of distribution is the most common method of determining the taxability of a property dividend. However, this distribution must be from earnings accumulated after February 28, 1913, or earnings of the current taxable year.[9]

Stock dividends.--Dividends in stock rank next to cash dividends in order of frequency and amount. When stock dividends are paid earned surplus is transferred to the capital stock account and stockholders merely hold a larger number of shares. There is no change in the total equity or the proportion of stock each shareholder owns. Stock dividends may be declared for various reasons. The declaration may give concrete evidence that earnings have been retained in the business and that the management has confidence in the ability of the company to produce a satisfactory return on the increased investment of the stockholders. A company may show good earnings but lack the cash necessary for a cash dividend or there may not be a market for the sale of new securities so that earnings may be the only source, or the most economical source, of funds for expansion. Stock dividends are nontaxable with two exceptions. A stock dividend is taxable

> (1) to the extent paid in discharge of preference dividends for the distributing corporation's current or preceding tax year; (2) if, at the election of any shareholder, the dividend is payable in money or other property.[10]

If a stock dividend is not of the same class of stock a shareholder already owns he will be taxed on the distribution.[11] Sometimes a stockholder may only be entitled to a fractional share which can be

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[9] Federal Tax Course, 1957, p. 1710.

[10] Ibid., p. 1705.

[11] Accountants' Handbook, p. 1046.

redeemed for cash. If the stockholder is given cash, instead of a fractional share, without any option to get a fractional share, the dividend is taxed. A stockholder may be given a fractional share, which can be redeemed for cash from the company, which would result in a taxable dividend even if he did not redeem the scrip certificates. Finally, the stockholder could be given a fractional share which can be sold on the open market. The dividend in this case would be treated as a tax free stock dividend--even if the company acts as an agent for the sale.[12] A dividend paid in shares of another corporation is not a stock dividend and is taxed just like a distribution of money. This was decided in Towne versus Eisner, later reversed, but only upon the ground that it related to a stock dividend that took nothing from the property of a corporation and added nothing to the interest of the stockholder.[13] In exempting stock dividends fro income taxation, the Supreme Court stated:

> A stock dividend shows that the company's accumulated profits have been capitalized, instead of being distributed to the stockholders, or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and is no longer available for actual distribution.[14]

If a stock dividend is paid in a new preferred stock issue, it is regarded as making no change in the equity position of the common stockholder and does not constitute taxable income. On the other hand, if additional shares of an existing preferred stock are issued, the

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[12] Federal Tax Guide, 1957, p. 2027.

[13] Towne v. Eisner, 245 U. S. 418 (1918).

[14] Eisner v. Macomber, 252 U. S. 189 (1920).

dividend is taxable income because it changes the proportionate interest of the stockholder.[15]

Stock rights.--Shareholders may receive rights to buy new shares of stock in proportion to their stockholdings. Usually these rights give the stockholder a chance to buy additional stock at a reduced price and for this reason have a value. A shareholder usually sells or exercises his rights, but he may decide to let them expire. Stock rights are usually nontaxable unless they are paid to satisfy a preference dividend. Also, if a shareholder has the option of taking money or property the rights will result in taxable income. Otherwise stock rights give rise to taxable income only when exercised or sold.[16] The court in Palmer versus Commissioner defined the taxability of stock rights in the following manner:

> The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition. They are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. Taxable income might result from their exercise. The question, then, is whether the distribution which results from the exercise of the rights must be regarded as a dividend if the reasonable value of the property at the time of exercise is more than the purchase price.[17]

Since the mere receipt of such rights does not result in income no loss is allowed if stock rights are received and permitted to expire without being exercised or sold. If a stockholder decides to exercise his rights he will be taxed on the excess of the fair market value of

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[15] Helvering v. Gowan, 302 U. S. 238 (1937).

[16] Federal Tax Course, 1957, pp. 1708-09.

[17] Palmer v. Comm., 302 U. S. 63 (1937).

the new stock he received over the subscription price offered to him. The third possible alternative is to sell the stock rights. In this case the entire amount of the proceeds of the sale will be taxed as ordinary income to the shareholder.[18] In Gibson versus Commissioner, the Court of Appeals held that the sales proceeds of rights constituted ordinary income up to the value of the rights at the time they were received. However, in that case the Commissioner raised no objection to taxing the proceeds in excess of that value as capital gain.[19]

It was noted above that if a stockholder allows his rights to expire without exercise or sale no loss is allowed; but it has been held that if a taxpayer purchases rights for a valuable consideration and allows them to expire without exercise or sale, a deductible loss is allowed.[20]

Bond rights.--Sometimes a stockholder will receive rights to subscribe to bonds which may be convertible into stock. If a stockholder receives bond rights and the bonds are convertible into stock the rights are nontaxable if

> (1) a dividend paid in the stock into which the bonds are convertible would be a nontaxable stock dividend and (2) the value of the subscription rights is attributable to the conversion privilege.[21]

If the bond rights can not be converted into stock they are taxed as property dividends which were previously discussed in this chapter.

Liquidating dividends.--A corporation may liquidate by redeem-

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[18]Federal Tax Course, 1957, pp. 1708-09.

[19]Gibson v. Comm., 133 F. (2d) 308 (1943).

[20]Mitchell v. Comm., 48 F. (2d) 697 (1931).

[21]Federal Tax Course, 1957, p. 1710.

ing the outstanding stock for cash or by distributing its assets to the stockholders in exchange for their stock. Most dividends represent distributions of surplus arising from earnings. However, a liquidating dividend represents a return of capital to the stockholder either in the form of dividends arising from the operation of wasting assets or in the distribution of the net assets to its owners. Most distributions in liquidation are treated as a sale of the stock, and not as a dividend. If a corporation distributes liquidating dividends in installments the stockholder is not required to report any income until he has recovered his cost. However, there have been cases where a corporation has transferred all or part of its assets to another corporation following or preceding the liquidation distribution. The Government may decide to treat this transaction as an ordinary dividend.[22] There are also several other exceptions to the general rule stated above that are too lengthy to discuss in the scope of this paper.

The preceding material in this chapter has been a discussion of the various types of dividend declarations as to whether they are generally taxable or nontaxable. Some of the common types of dividends previously discussed were listed as nontaxable distributions. There are, however, a number of other tax provisions that may cause a dividend to be wholly or partially exempt from income tax, either by legal provisions or by the nature of the dividend itself. The following material will attempt to point out some of these exceptions.

Distributions That Are Not True Dividends

Several companies distribute dividends that are in effect partial

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[22] Federal Tax Guide, 1957, pp. 3428-30.

returns of capital. Such so-called dividends are not reported as taxable income, but rather serve to reduce the cost of a stockholder's investment. Common examples of this type of dividend are distributions from mutual insurance companies and patronage dividends. Dividends on deposits or withdrawable accounts in domestic building and loan associations are actually interest. Amounts paid on deposits or withdrawable accounts in the following organizations are interest and should be reported as such: (1) mutual savings banks; (2) cooperative banks; (3) domestic savings and loan associations; (4) Federal savings and loan associations; and (5) credit unions without capital stock. It must be remembered that dividends on <u>capital stock</u> of the above organizations (dividends on the non-withdrawable stock), are true dividends and should be reported as dividend income.[23]

Dividends That Are Wholly or Partially Exempt

Dividends on the following obligations are wholly exempt from tax if they were issued prior to March 28, 1942:

(1) Federal Land Banks; (2) National Farm Loan Associations; and
(3) Federal Reserve Banks.[24]

Dividends on obligations of the instrumentalities of the Government issued on or after March 28, 1942, are fully taxable. Regardless of the exemption from income tax of dividends paid on the stock of Federal Reserve Banks, dividends paid by member banks have always been treated like dividends of ordinary corporations.[25]

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[23] <u>Your Federal Income Tax, 1956</u>, (Pub. No. 17, Washington, D. C.: I. R. S., 1956) pp. 36-37.

[24] <u>Federal Tax Course, 1957</u>, p. 1703.

[25] <u>Ibid.</u>

The Dividend Exclusion and Credit

An individual may get a flat exclusion from gross income of the first fifty dollars of dividend income received during the taxable year. If both a husband and wife have dividend income, they could exclude a maximum of one hundred dollars. When two or more persons own stock as tenants in common, joint tenants, or tenants by the entirety, dividends are considered to be received by each owner to the extent he is entitled to share them. If dividends are community property each spouse is considered to receive one-half of the dividends.

In addition to the flat exclusion of dividend income described above, there is also a credit for dividends received. This is a credit against the tax equal to four per cent of the amount of dividends received from domestic corporations which are included in gross income. It should be noted that this is not a further exclusion from gross income after the flat fifty dollar exclusion. All dividends in excess of the fifty dollar exclusion must be included in the gross income and taxable income on which the tax rates are applied. After the tax is computed, this four per cent of the dividends included in taxable income is deducted from the tax as a credit. The dividends received credit and exclusion are allowed only for dividends from domestic corporations. Neither is allowed for dividends received from China Trade Act corporations, or corporations deriving most of their income from United States possessions. Nonresident aliens who are not engaged in trade or business in the United States with gross income less than $15,400 are not allowed any dividend exclusion or credit. The fifty dollar exclusion and the dividends received credit are denied to corporations which are life insurance companies and mutual insurance companies other than marine and other mutual fire insurance companies issuing perpetual policies. The exclusion and credit are allowed for dividends received from all other taxable insurance companies. Dividends paid by exempt charitable organizations and by so-called "exempt" cooperatives are also not allowed the exclusion or credit relief. True patronage dividends paid by either exempt or taxable cooperatives also are taxable in full. The only dividends from banks that are not allowed the exclusion or credit are those paid or credited by mutual savings banks, cooperative banks, and domestic building and loan associations on their deposits or withdrawable accounts. As discussed previously, these payments or credits are more in the nature of interest and are allowed no exclusion or credit.[26]

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[26] Federal Tax Guide, 1957, pp. 2020-23.

CHAPTER II

CONSTRUCTIVE DIVIDENDS

Introduction

Corporations frequently make payments to stockholders that are not formally designated as dividends. In numerous cases, where it was clearly evident that the payment was made in a guise to permit the corporation to take a deduction, the Government has succeeded in taxing the distribution as a dividend. Sometimes payments are used as a device to permit a stockholder to avoid taxes. Payments of this nature may also be construed to represent a taxable dividend even though the distribution was in proportion to the recipient's stockholdings and was purported to be based upon a consideration.[1]

There are countless dealings that a stockholder might have with a corporation that could be taxed as dividends. Because it is impossible to cover every conceivable transaction that may result in a taxable dividend the following discussion will be limited to those cases that stockholders should be especially aware of because they have appeared frequently in the United States Tax Courts, burdening many taxpayers with liabilities they never knew existed.

It should be remembered that the intention of the parties does not necessarily govern the taxability of a transaction. In

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[1] Federal Taxes, 1956 (New York: Prentice-Hall, Inc., 1955) I, p. 9015.

cases where it is evident that the distribution was used as a means of distributing earnings the stockholder will be held liable for the tax, even though the payment was not made in an attempt to defraud the Government.

As noted above, a dividend does not have to be formally declared to be taxed as a dividend. This was the decision of the Commissioner in The Security National Bank of Los Angeles versus Commissioner. One of the issues involved in that case was whether or not the Commissioner erred in holding that a transfer of land was equivalent to the receipt by the decedent of a dividend of $509,600. The land belonged to the Huntington Land and Improvement Company, in which the decedent owned all of the stock. The decedent wanted to purchase some objects of art from a certain art dealer for the Henry E. Huntington Library and Art Gallery. He suggested to the vice president of the corporation that the corporation transfer the land to the trust so that the trust, in turn, could transfer the land to the dealer in exchange for the art objects. The corporation made the transfer on January 25, 1927, pursuant to a resolution of the directors in which the transfer was described as a gift. The Commissioner held that the transaction was equivalent to the distribution of a dividend to the decedent. He also held that the corporation had ample earned surplus from which to distribute a dividend of $509,600. The end result was that surplus had been reduced by the book value of the land, the trust had the art objects, and the decedent had fully accomplished his sole purpose in having the transfers made. Because the corporation acted solely to accommodate the decedent, the transaction amounted to the distribution of a taxable dividend to the decedent even though no dividend was formally declared.[2]

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[2]Security First National Bank of Los Angeles v. Comm., 28 B.T.A. 289 (1933).

Transactions That May Result in Constructive Dividends

<u>Excessive compensation</u>.--Excessive compensation paid by a corporation to its officers may be taxed as a dividend. Compensation claimed as a deduction by a corporation must be reasonable in amount and must be paid purely for services. Since a stockholder is required to pay tax on the full amount of any salary he receives the only party gaining any <u>tax</u> advantage in this transaction would be the corporation, which would claim the excessive salary as a deductible expense.[3]

<u>Excessive rents</u>.--Excessive rents may sometimes be taxed as constructive dividends. In the case of <u>Standwick's, Incorporated</u> versus <u>Commissioner</u> it was held that the excess of rent payable to the wife of the sole owner of the taxpayer corporation over the rent the husband had to pay to the owners of the property occupied by the corporation was not deductible by the corporation, but was a taxable dividend to the sole owner of the corporation. This company was incorporated in 1927 with Fred A. Alperstein as sole owner. Six individuals, unrelated to Alperstein, had been the owners of the premises at that address and had leased the premises to Alperstein for a fixed annual rental under a succession of leases. On June 18, 1943, a new lease agreement was made with the owners for a term beginning July 1, 1943, and expiring December 31, 1949. The annual rent was to be $10,680 plus real estate taxes on the property in excess of $2,000. Alperstein requested the landlords to consent to the assignment of the lease to his wife. Their consent was given on June 28, 1943. She was required to pay her husband the amounts which he had been required to pay to the owners, leaving her the right to sublet the premises, but she still remained liable to Alperstein for the performance of the sublease and the

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[3] <u>Federal Tax Course, 1957</u>, p. 1814.

original lease. The president of Stanwick's, Incorporated, entered into an agreement with Alperstein's wife whereby they leased the property from her under the same terms as the original lease except that the rent was to be the equivalent of six per cent of the gross sales made on the premises beginning July 1, 1943.

The Commissioner held that it was obvious that rent based upon six per cent of gross sales would far exceed that being paid the owners. This actually resulted in payments to Alperstein's wife which were more than twice the amount payable to the owners. The court held that Alperstein's command of the income of Stanwick's, Incorporated, thus paid to his wife, made it taxable to him. The Commissioner stated:

> The whole arrangement is superficial, artificial, and not an arm's length transaction between people having different interests dealing for some genuine business purpose. It is lacking in reality and is merely a device to reduce taxes.[4]

<u>Excessive royalties</u>.--The payment of excessive royalties by a corporation to its principal stockholders may be taxed as a distribution of profits. It was decided in the appeal of <u>Peterson and Pegau Baking Company</u> versus <u>Commissioner</u> that payments made by the company to its principal stockholders on account of alleged royalties for the use of a pretended secret process were distributions of profits. P. F. Peterson and L. M. Pegau owned the entire capital stock of this baking company. The corporation had used, under a contract with Ivan B. Nordheim Company of Pittsburgh, Pennsylvania, a trade-name for bread, known as "Tip Top Bread", and a formula for making bread. The corporation entered into a written contract with Peterson and Pegau, agreeing to pay each of them, in equal amounts, a royalty equal to one-third of the net profits for the use of a certain alleged secret process in the

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[4]<u>Standwick's, Inc</u>. v. <u>Comm</u>., 15 T. C. 556 (1951).

baking of bread. Peterson and Pegau received for the three years in question the amounts of $41,786.64, $39,734.76, and $26,108.50, as alleged royalties for this secret process. The Commissioner declined to allow these payments as deduction from gross income of the company, claiming that the alleged royalty contract was a mere cloak for the disguise of a distribution of profits in an effort to reduce taxable income thus making it taxable as a dividend to the two stockholders.[5]

Insurance Premiums.--Premiums on business insurance may result in taxable dividends. An Income Tax Ruling, Section 215, Article 294 states:

> Where a corporation insures the life of its president, the stockholders being beneficiaries in proportion to their stockholdings and the wife of the president (not herself a stockholder) being a beneficiary in proportion to her husband's stockholdings, no deduction for the payment of premiums can be allowed since the corporation itself is indirectly a beneficiary under the policy. The premiums paid on such a policy are a charge against surplus and represent dividends to the stockholders subject to surtax to the extent that such premiums are paid out of earnings or surplus accumulated since February 28, 1913. This applies as well to the officer upon whose life the insurance is carried.[6]

Payment by a Corporation of a Claim Against a Stockholder.--Ordinarily, if a corporation pays a debt on behalf of a stockholder, the shareholder will be considered to have received a constructive dividend. However, in the case of Ruben versus Commissioner it was held that the escape from a contested money claim by the force of circumstances of the action of others did not give rise to taxable income.[7] It is obvious that the taxability of transactions of this nature will depend entirely upon the individual facts as they exist. There is no evidence of any unanimity of opinion among the courts in this respect.

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[5] Peterson and Pegau v. Comm., 2 B. T. A. 637 (1925).

[6] Internal Revenue Cumulative Bulletin, O. D. 659 (Washington: U. S. Gov't. Printing Office, 1920), p. 192.

[7] Ruben v. Comm. (8 Cir.; 1938), 97 F. (2d) 926 (1938).

dividends in a guise to attempt to avoid taxes and defraud the Government. For example, the evidence in the case of Pompeian Manufacturing Company versus Commissioner revealed that payments purporting to be for goodwill were actually used as a front to distribute profits to the stockholder, Mr. F. W. Stecher. Mr. Stecher owned the Pompeian Manufacturing Company, which was operated as a sole proprietorship. Stecher wanted to get out of business, so he sold his firm to a corporation with the provision that he was to be paid for the value of his business by the issuance of 996 shares of par value one hundred dollar capital stock of the corporation. The agreement also stipulated that Stecher was to receive $20,000 annually for ten years as a royalty and goodwill for the business he sold, but this $20,000 payment was contingent upon the earnings of the corporation. The agreement provided that if the earnings did not equal the above amount, the amount payable each year would be equal to the yearly earnings before any dividends were paid on the capital stock. The Commissioner ruled that this was obviously a distribution of profits and would be taxed as a dividend.[10]

Release of stockholder's debt.--The tax courts have been confronted with numerous cases in which a stockholder has been relieved of a debt he owed to his corporation. Transactions of this nature usually result in taxable income to the stockholder. This is true even though the dividends are not distributed ratably according to the stockholdings. This was the decision of the Commissioner in the case of Dowling versus Commissioner. In this case, the taxpayer's corporation held a special meeting to determine the disposition of several special loan accounts that appeared on the books of the corporation. At this meeting, a resolution was unanimously adopted by all the stockholders to cancel

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[10] Pompeian Mfg. Co. v. Comm., 1 B. T. A. 825 (1925).

all the debts mentioned above. None of the stockholders had rendered any services to the corporation as consideration for the release of their debts. The court held that the sum due of $74,474.46, was a constructive dividend to the stockholders based on the fact that the evidence disclosed an intention to distribute profits without regard to stockholdings.[11] Subsequent court decisions have upheld this ruling.

Waiver of dividends.--It is interesting to note that a majority stockholder may be allowed to waive his rights to future dividends without incurring a tax liability on future dividends paid to minority interests. In a recent ruling a majority stockholder waived all right, title, and interest in future undeclared dividends for a certain period of time in order to increase the surplus of the corporation to enable it to meet certain legal requirements regarding contemplated business. There was no family, or direct business, relationship between the majority and minority stockholders of this corporation. Even though dividends were subsequently paid to minority interests the court held that this did not increase the interest of the waiving stockholder in the remaining or future surplus of the corporation. They also stated that any dividend payments to minority stockholders would not result in income to the waiving stockholder and the corporation would not realize income on account of the waiver.[12]

Withdrawals by stockholders.--Stockholders frequently make withdrawals from corporations which are usually considered to be loans. However, cases may arise where these withdrawals are actually only loans in disguise and will be taxable as dividends to the stockholder. The following circumstances may show that the withdrawals are taxable

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[11] Dowling v. Comm., 13 B. T. A. 787 (1928).

[12] Internal Revenue Cumulative Bulletin, Revenue Ruling 45 (1953), p. 178.

dividends as distinguished from loans:

> (1) that they are made by the sole stockholder or by principal stockholders; (2) that they are not secured by stockholder's note or otherwise and that no interest is paid by the stockholder or charged by the corporation; (3) that the corporation has a substantial surplus; (4) that there is no evidence of intention on the part of the stockholder to make repayment.[13]

Conversely, the following circumstances may show that the withdrawals are loans which are not taxable as a dividend:

> (1) that they are charged to account of the stockholder and carried on the books of the corporation as accounts receivable; (2) that they are secured by the stockholder's note or otherwise and interest is paid thereon; (3) that they are greater than any dividends the stockholder may be entitled to on shares which he holds; (4) that they are regarded as an indebtedness by the stockholder and reduced by cash payments from time to time.[14]

A good example of a withdrawal taxed as a dividend is the recent tax case of <u>Vassallo</u> versus <u>Commissioner</u>. Each year Vassallo, a sole stockholder, withdrew funds from a corporation and spent it as he chose. Vassallo argued that the large amounts of additional income which the Commissioner determined he received, supposedly as dividends from the corporation, should be reduced by the amount of tax liability and penalties which the corporation should have paid on its unreported income. In response to this the Commissioner stated:

> There is no question that Vassallo Incorporated was a bona fide corporation and carried on business as such. Regrettable as this may be, a taxpayer having adapted the corporate form to conduct his business activities, must accept the tax consequences which result therefrom.[15]

The Commissioner held Mr. Vassallo liable for personal income taxes on the amounts he withdrew. The corporation was also forced to pay corporate income tax on the same funds, as its income.[16]

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[13] <u>Federal Taxes, 1956</u>, I, pp. 9026-27.

[14] <u>Ibid.</u>

[15] <u>Vassallo</u> v. <u>Comm.</u>, 23 T. C. 256 (1955).

[16] <u>Ibid.</u>

In another recent tax case a stockholder had also made withdrawals from a corporation, but in this case he had entirely repaid the loans before he had received any notice of the Commissioner's intention to tax the transaction as a constructive dividend. The Commissioner tried to tax the transaction as a dividend inferring that there was no security for the amounts withdrawn and that they were not evidenced by notes or interest. However, the court ruled that the withdrawals were nevertheless loans because there was a clear intent to create a debtor-creditor relationship evidenced by the fact that the taxpayer had entirely repaid the withdrawals before he had any notice from the Commissioner.[17]

The nature of the transaction and the intent of the parties are the main factors governing the determination of whether or not a withdrawal is taxable as a dividend. It was recently held that an unauthorized corporate withdrawal to pay a gambling debt did not constitute a dividend. In the case involved the taxpayer lost a large sum of money gambling and withdrew money from four family-owned corporations in which he was an officer and stockholder, hoping that his luck would change and that he would be able to restore all the unauthorized withdrawals. At frequent intervals he deposited his winnings and salaries in the corporation's bank account as a partial repayment, but his winnings were never sufficient to offset the withdrawals completely. After considering all the evidence, the court concluded that the withdrawals were loans and that they therefore did not represent distributions of dividends or capital.[18]

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[17]<u>Dalton</u> v. <u>Comm.</u>, T. C. M., 1957, p. 20.

[18]<u>Freeman</u> v. <u>Comm.</u>, T. C. M., 1957, p. 14.

CHAPTER III

TRANSACTIONS AND DISTRIBUTIONS THAT MAY BE TAXED AS DIVIDENDS

Introduction

In addition to the transactions discussed in the preceding chapter, there are a number of other dealings a stockholder might have with a corporation that may result in a taxable dividend to him. The purpose of this chapter is to illustrate some recurring transactions of this nature that frequently confront the stockholder.

Redemption of Stock

One very common transaction that may be taxed as a dividend because it is very often used to distribute profits in disguise is the redemption of stock. A redemption usually occurs when a corporation acquires its stock from a stockholder for money or other property. It does not make any difference if the stock is cancelled, retired, or held as treasury stock; it is still considered a redemption.

In most cases, when stock is redeemed, the transaction is treated as though the shareholder sold his stock to the corporation and the taxpayer is subject only to a capital gains tax. If there are sound business reasons (other than tax avoidance) for the redemption, it usually will be treated as an exchange. The courts consider the redemption a question of fact, so if the redemption is purely for the purpose of tax avoidance the test is not met and the redemption will be termed essentially equivalent to a dividend and taxed as such. In order for a stockholder to avoid being taxed on a redemption it is usually necessary for him to hold less than fifty per cent of all classes of stock entitled to vote after the redemption. The stockholder must also own less than eighty per cent of the stock owned by him before the redemption occurs. An exception to this provision is when a stockholder disposes of his entire equity interest according to a plan, in which case the redemption is usually considered a sale.[1]

A redemption due to a contraction of a corporation's business is not usually held to be essentially equivalent to a dividend. However, a partial stock redemption may result in a dividend despite the fact that the business contracted. This was decided in the case of Chandler Estate versus Commissioner in which the decedent was president-manager of a family corporation operating a department store. Due to his illness the corporation sold the store, business, and inventory for cash. Later in the year the corporation began operating a somewhat smaller store. Since the capital requirements were less, the corporation redeemed one-half of the stock at book value and reduced the legal capital. The tax court, applying the "essentially equivalent" test, held that the distribution (to the extent of the corporation's surplus) was taxable as a dividend. They reasoned that the reduction of the large cash account of the firm could have been accomplished by a dividend. They also implied that the tax saving was not a controlling motive and that the contraction of the business was an important, but not the controlling, factor.[2]

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[1] Federal Taxes, 1956, I, p. 9150-51.

[2] Chandler Estate v. Comm., 22 T. C. 115[illegible]

Another form of redemption which is very commonly used to avoid taxes is the preferred stock bail-out. This is accomplished by having a corporation distribute a non-taxable preferred stock dividend to the stockholder, who in turn sells this same stock to a third person. Then, the corporation redeems the stock from this third person thus enabling the taxpayer to treat the proceeds of the sale and redemption as a capital gain. A special rule has been enacted to close this loophole. This rule infers that, where the stock is sold, the dividend is measured by the sales proceeds up to the stock's ratable share of the earnings at the time of issuance. If the amount the stockholder receives for the stock exceeds the stock's share of the corporation's earnings and profits the excess is treated as a capital gain. When the stock is redeemed, the amount taxed as a dividend is measured by the earnings at the time of the redemption.[3] The special rule mentioned above was a provision of the 1954 Code, designed mainly to prevent a stockholder from receiving a nontaxable stock dividend and later selling it under a plan to avoid dividend income.

Distributions From Depreciation and Depletion Reserves

A corporation will frequently distribute a dividend out of a depreciation or depletion reserve. This type of dividend usually results in a nontaxable distribution because it is considered a return of capital. However, no dividend distribution can be made from such a reserve until all earnings or profits of the corporation accumulated after February 28, 1913 have been first distributed. This was decided in a case involving John K. and Sallie Beretta, who were stockholders of a corporation which sold part of its assets for cash. Soon afterwards,

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[3] Federal Taxes, 1956, I, p. 9184-85.

this cash and an amount from a depreciation reserve was distributed to the stockholders. The stockholders contended that the portion of the dividend they received as a distribution from this reserve was a return of capital and not a taxable dividend. The court stated:

> For purposes of taxation a corporation can not distribute its depreciation reserve until after all its earnings and profits accumulated after February 28, 1913, have first been distributed.[4]

The above decision also took into account that the corporation had previously capitalized $250,000 of its earned surplus and paid a stock dividend. The court held that this amount was earnings and profits accumulated after February 28, 1913, and would have to be distributed as a dividend before a nontaxable distribution could result from a depreciation reserve.[5]

Many investment trusts and corporations engaged in the extraction of natural resources use a percentage depletion allowance. When this allowance is used, the annual deduction by the corporation usually exceeds the allowance under general depletion methods. This difference is taxed as a dividend when it is distributed to the stockholders.[6]

Dividends Repaid to a Corporation

Sometimes stockholders repay dividends to their corporation. It is important here to distinguish between a legal and illegal dividend. It is well established that a legal dividend is income to a stockholder in the year paid despite the fact that it is later rescinded. One reason for this decision is that a dividend declaration creates a debtor-creditor relationship between a corporation and its stockholders and the directors have no power to revoke their action. A still more important reason is that the stockholder receives the dividend without

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[4]John K. Beretta v. Comm., 1 T. C. 86 (1942).

[5]Ibid.

[6]Federal Tax Guide, 1957, I, p. 3077.

restriction and is free to use the distribution as he desires.[7] A Texas court recently used the same reasoning when they held that loans to a stockholder of a closely held corporation were dividends even though they were later repaid. In this case, the taxpayer and his wife contended that moneys withdrawn by the husband in 1946, 1947, and 1948 from the closely held corporations they controlled were loans because they were later repaid in 1949 and 1950. The court said:

> The moneys withdrawn were dividends because they were received by the husband out of earnings and profits. The repayment of the "loans" was a contribution to capital and increased the taxpayers' basis.[8]

There was no evidence, in this case, that the receipts by the stockholder were loans. In other cases it has been held that where there was ample evidence that the transaction was a loan, the payments would be taxed to the recipient as such.

Repayments of legal dividends to avoid the impairment of the corporation's capital are usually held to be a receipt of income in the year received. This ruling was upheld in a tax case involving a stockholder who received a dividend of $24,929.58 as his share of a total distribution of $150,000. Later, it was found out that the dividend payment created a deficit which was prohibited by New York law. To rectify this situation, the board of directors of the corporation passed a resolution rescinding the dividend and at the same time declared another dividend in a less amount. The stockholders subsequently returned the difference to the corporation. The parties proceeded to agree on an adjustment of the earnings and profits of the company. The court decided that the taxpayer should be taxed in the current year upon his share of the company's earnings even though the amount retained by him

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[7] Ibid., p. 9039.

[8] Stoddard, D. C. Tex. (1957).

in the following year was less than this amount. The courts reasoning was:

> While New York law prohibits the declaration of dividends which impair capital, such a distribution is not void and no liability is placed by the statute upon the shareholders either to respond to creditors or to refund to the company the amounts paid.[9]

An illegal dividend is generally taxable in the year received, but under the "claim of right" rule promulgated by the 1954 Code a taxpayer may get a deduction for dividends repaid in the year of receipt. Under the old 1939 "claim of right" rule a stockholder was forced to take his deduction for the repayment of the dividend in the year of repayment. However, under the new rule passed and included in the 1954 Code, if the deduction for the repayment is more than $3,000, the repayment can be subtracted from income in the year of receipt and the tax for that year can be recomputed. If this results in less tax than claiming the deduction in the year of repayment, the stockholder may elect to use the former method.[10] This election obviously gives a stockholder an advantage because his income from year to year may vary, in which case he can choose to offset this income in the most advantageous manner.

As noted before, an illegal dividend is considered to result in taxable income in the year of receipt regardless of the treatment offered the stockholder for a deduction in the year of repayment. This principle was upheld in a tax court decision where the shareholder argued that he should not be taxed on the excess amount of dividends he received. His argument was based upon the fact that he had later returned the dividends to his corporation. The Court in turn stated:

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[9] Charles G. Duffy v. Comm., 2 T. C. 568 (1943).

[10] Federal Taxes, 1956, I, p. 9100.

> We are not concerned with the question of whether this corporation made the distribution in violation of Texas law. Whether the resolution of the stockholder's meeting of February 28, 1939 and the book entries made after the dissolution was effectual to cause a return of the distributions in question we do not decide. Where an illegal dividend is declared and paid in one year is rescinded and repaid in a later year, the stockholders must include such dividend in income in the year received.[11]

And in Pennsylvania versus Robertson, the court stated:

> A cardinal principle of federal income taxation requires annual returns and accounting; and this principle requires the determination of income at the close of the taxable year without regard to the effect of subsequent events.[12]

Credits On Unissued Stock

Many corporations offer their employees an opportunity to purchase shares of stock. In agreements of this nature the title to the stock usually remains in the corporation until the stock is fully paid for. The purchase price of this stock is sometimes reduced by the amount of so-called dividends on this unissued stock. This type of arrangement usually results in additional compensation to the employee rather than a dividend because dividends can not be declared on unissued or treasury stock.[13] To make the situation more complicated, there have been occasions when the payments on unissued stock have been contingent upon the fulfillment of certain conditions by the stockholder. The courts are not in full agreement on this issue. One court held that the transaction resulted in additional compensation to the employee, as stated above, while a second court took the opposite viewpoint and treated the agreement as being nontaxable until the stockholder had fulfilled all the terms of the agreement and owned the stock.[14]

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[11] Shield Co., Inc., v. Comm., 2 T. C. 763 (1943).

[12] Pennsylvania v. Robertson, 115 Fed. (2d) 167 (1940).

[13] Federal Taxes, 1956, I, p. 9037.

[14] Internal Revenue Cumulative Bulletin, O. D. 763 (June, 1921) p. 76.

CHAPTER IV

MISCELLANEOUS PROVISIONS AND RECOMMENDATIONS

Introduction

The last two chapters were limited to a discussion of certain distributions and transactions which might result in taxable dividends to the stockholder. Once a stockholder has concluded that he has received a taxable dividend he must determine the manner in which it is taxed (discussed previously in Chapter I) and the correct year to report this income. If a shareholder buys and sells stock, it will be necessary to determine the taxation of dividends between the seller and purchaser of the stock. The text of this chapter will also include the author's recommendations and conclusions.

Taxation of Dividends Between Sellers and Purchasers of Stock

When stock is traded there are usually three dates that are of importance to the shareholders. First, there is the declaration date, or date the board of directors votes the dividend. The next date, the record date, is the date on which a person has to be a stockholder of record to be eligible to receive the dividend. The last date, the payment date, is the date on which the dividend is actually paid. The stockholder of record on the record date receives the dividend and will be held liable for the tax. The first day on which it is too late for a seller to avoid being the holder of record on the record date (or for the buyer to become the holder on that date) on a sale or exchange is called the ex-dividend date. Consequently, if a person buys stock before the ex-dividend date, the dividend will be taxable to him. Likewise, a person buying on or after the ex-dividend date would not receive the dividend nor be held liable for the tax on this distribution. Most stock exchanges have an arbitrary rule as to when a stock is "ex-dividend". On the New York Stock Exchange, stocks sell "ex-dividend" on the second full business day preceding the record date, but if the record date is a holiday, stocks sell "ex-dividend" on the third full business day. Because there is a lapse between the time a trade is executed on the exchange and the time the stock is required to be delivered, a person should acquire the stock at least four or as many as six days before the record date to enable him to become a stockholder of record in time to get the dividend. Similarly, a shareholder would have to sell that many days before the record date to avoid receiving the dividend. If there is no record date named the dividend is taxable to the person owning the stock on the declaration date.[1]

Time for Taxation of Dividends

A stockholder is not taxed on a dividend until it is made subject to his demand regardless of when the dividend was declared. If a check is received, the stockholder is deemed to have received income subject to his demand and will be taxed upon the receipt of the check regardless of the date he cashes this check. Many companies follow the policy of paying dividends by check so that the stockholders will not receive them until the next year. The income in this case

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[1] Federal Tax Guide, 1957, p. 2023-25.

would be reported in the year of receipt; but if, by a regular mailing or any other reasonable action, the stockholder could get the dividend in the prior year he would owe a tax in that year. If the stockholder was given notice at the end of the year that dividends were declared and his account was credited, he would have to report the income in that year, because it would be deemed a constructive receipt even though it was not actually paid until a later date. Likewise, if the shareholder requested that the check be mailed in an effort to delay realizing income, the dividend would be taxed in the current year mentioned above. Many savings and loan associations mail dividend checks at the end of the year, but the stockholder does not receive the check until the following year. Where this is the practice, the dividends are taxed in the year they are received in the mail. This is true even though the shareholder could have appeared in person at the association's offices on the last day of the year and received the check.[2] It is evident that the time for taxation of dividends will be influenced by the customs of the various firms distributing the dividends.

Frequently a preferred stockholder will receive payments for accumulated back dividends. Because dividends do not accrue the same way interest does (interest accrues whether paid or not) they are taxable only when constructively received, regardless of the period for which they are paid.[3]

Recommended Tax Savings for Stockholders

A stockholder should realize that there are various types of tax savings available to him. In some instances a shareholder can

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[2]Ibid.

[3]Ibid.

convert his ordinary dividend income into a capital gain by selling stock on which a dividend is declared but not yet paid. If this shareholder would sell his stock before the record date, the purchaser would receive the dividend and pay the tax. The selling price would, in most cases, reflect the dividend which would become part of the profit to the seller and would be subject to capital gain treatment. This is also true when preferred stock has dividends in arrears about to be paid, in which case the stockholder could sell before the record date and repurchase afterwards to enable him to get a capital gain on the transaction instead of ordinary income.

Still another way of avoiding taxable dividend income is to buy stock in a company paying stock dividends. Since stock dividends are usually nontaxable, the shareholder has an opportunity to increase his investment with the possibility of selling the stock at a future date and getting capital gain treatment on the transaction.

It would also be advantageous for a prospective stockholder to try to buy stock which returns capital instead of profits. For example, many ore and mining companies frequently make distributions from depletion or depreciation reserves based on cost. This type of dividend is allowed a taxfree treatment and merely reduces the basis of the stock to the investor. Of course it must be remembered that when the basis is lowered the stockholder will realize more income on a subsequent sale of this stock; but it is a method of postponing income, especially if the stockholder is in a high tax bracket.

One more potential tax saving worthy of consideration is the possibility of transferring stock to the immediate members of a stockholder's family in order to build up a maximum dividend exclusion within the family. This can be accomplished by transferring stock

The Internal Revenue Code of 1954, in its dividend provisions, made an attempt to reduce the effect of double taxation by granting the stockholder a fifty dollar exclusion and a four per cent dividend credit. This was really a form of compromise between those who advocated double taxation and others who wanted to completely eliminate this inequity. The 1954 provision seems to be somewhat imperfect because it is nothing more than a modest attempt to begin to depart from the double tax structure. In most cases the amounts of change are so small they make no notable difference in the pattern of tax distribution from the viewpoint of tax equity. The author believes these provisions could be extended and strengthened to attempt to approach the ultimate goal of reducing, or perhaps eventually eliminating entirely, the extra taxation of dividend income. Such a move is very unlikely in the near future, but the revised 1954 dividend provisions are at least a step in this direction.

The dividend credit has given some relief to the individual recipient of dividends from taxable domestic corporations. However, although this credit provision reduces the rate of extra taxation for both high and low income stockholders, the disparity between them is widened by this credit provision resulting in additional benefits to the stockholder who receives large dividend returns. On the other hand, the fifty dollar dividend exclusion, in general, clearly gives the greatest relief to the low-income taxpayer; but for all but some very small dividend recipients, the amount involved is insignificant compared with the four per cent credit.

Conclusions

The taxation of dividends poses a very difficult problem. Our modern business units have become so complex that the government staffs available for large scale tax revision studies have been inadequate. Even though several technical and nongovernmental groups have assisted in these studies, the gaps in the tax laws are not likely to be completely filled.

The author feels that additional tax revision programs are requisite. There seems to be a definite need for further study in the field of constructive dividends. The cases cited in this paper have revealed several instances where it is almost impossible to clearly relate a specific tax question to the tax law. This, in turn, necessitates court action to decide the issues at hand. Most of these cases are decided on the basis of previous decisions, the intent of the parties, and the conditions as they exist, resulting in injustices to many of the parties involved.

Maybe some day there will be technically competent organizations that will realize the importance of maintaining a more adequate force of legislative personnel on both the Treasury and Congressional staffs. Until then the stockholder will continue to be burdened with politics, poor legislation, and tax provisions that can not be interpreted with enough certainty to formulate an accurate decision on the conditions as they exist.

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