

Corporate current and accumulated earnings and profits

We have received inquiries about the tax rules under which the corporate distributions of money to shareholders are taxed as dividends.

Whether a distribution is a dividend is determined by the corporation's "earnings and profits (E&P)." To the extent the corporation has E&P, the distribution is taxed as a dividend. Dividend income is taxed at capital gains rates. If the amount distributed exceeds E&P, it is a nontaxable return of the shareholder's capital rather than a dividend and is applied against the shareholder's basis in stock. Any remaining amount of the distribution (in excess of the amount applied against the basis) is taxed as gain from the sale of stock.

Example: Sam is the sole shareholder of XYZ, Inc. and has a \$10,000 basis in his stock. XYZ has \$5,000 in earnings and profits and distributes \$8,000 to Sam. Sam is taxed on a dividend of \$5,000 (XYZ's E&P) and the remaining \$3,000 reduces his basis in his stock from \$10,000 to \$7,000.

Example: Sally is the sole shareholder of ABC, Inc. and has a \$10,000 basis in her stock. ABC has \$5,000 in earnings and profits and distributes \$17,000 to Sally. Sally is taxed on a dividend of \$5,000 (ABC's E&P) and the remaining \$12,000 reduces Sally's basis in her stock from \$10,000 to zero and also results in her being taxed on \$2,000 of gain (the excess of the \$12,000 non-dividend portion of the distribution over her \$10,000 basis).

In the above examples, the corporation was wholly owned by one shareholder. If there is more than one shareholder, the corporation's E&P is allocated proportionately among the distributions to the shareholders.

Accumulated or current E&P. E&P will cause a distribution to be taxed as a dividend whether they are "current" or "accumulated." The current E&P (E&P earned in the year of the distribution) is drawn upon first. If the distributions made during the year exceed current E&P, the current E&P is allocated among the distributions proportionately to the amount of each distribution. If the distribution exceeds the corporation's current E&P, it will be a dividend to the extent of the corporation's accumulated E&P (undistributed E&P from earlier years). Accumulated E&P is allocated among distributions by the corporation in the order in which they are made (unlike distributions out of current E&P which are allocated in proportion to the distributions).

Example: DEF Corp has \$6,000 in current E&P and \$5,000 in accumulated E&P. It distributes \$10,000 to its shareholders on April 1st and \$20,000 on October 1st. The current E&P is allocated to the distributions first. The April distribution is one-third of the total distributed during the year (\$10,000/\$30,000). Therefore, 1/3 of current E&P, or \$2,000, is allocated to the April distribution. In similar fashion 2/3 of current E&P, or \$4,000, is allocated to the October distribution. Of the remaining \$8,000 of the April distribution (\$10,000 distribution - \$2,000 from current E&P), \$5,000 is treated as coming from accumulated E&P, thus using up accumulated E&P entirely. Thus, a total of \$7,000 of the April distribution is a dividend (\$2,000 from current E&P and \$5,000 from accumulated E&P) while only \$4,000 of the larger October distribution is a dividend (from current E&P).

The different rules for allocating current and accumulated E&P among corporate distributions should not have an impact on an individual who is a shareholder for the entire year. However, a prospective shareholder who will acquire his stock after a

distribution has already been made during the corporation's tax year may be affected by these rules. Such shareholder should seek to determine both the amount and nature of the corporation's E&P. Accumulated E&P will attach to the earliest distributions (which are not covered by current E&P) and, if it's used up, later distributions will not be dividends. Conversely, the existence of current E&P (which is allocated proportionately to all distributions) would make it more likely that distributions later in the year will be treated as dividends. Of course, if the corporation has E&P in excess of total expected distributions for the year, all distributions will be dividends and the distinction between current and accumulated E&P will have no impact.

Please note that a deficit in accumulated E&P will not reduce current E&P. Thus, for example, if a corporation with a history of losses finally has earnings and makes a distribution in that year, the current E&P, even if dwarfed by the accumulated losses, will cause the distribution to be taxed as a dividend. On the other hand, a deficit in current E&P does reduce accumulated E&P and can prevent a distribution from being a dividend.

Finally, please note that "earnings and profits" is a special tax concept and is determined under rules different from those for determining retained earnings or taxable income. It is important to get the relevant data from the corporation in order to address E&P issues. (This would include, among other things, information about mergers to which the corporation was party and redemptions of its stock.)