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My topic is "The Limitation on Income from Dividends" or, better put, "The Limitation on the Extent to which Dividends will be Taxed as Ordinary Income." This statutory limitation has two prongs. If there is a distribution in the nature of a dividend, it will not be treated as ordinary income to the recipient unless the distributing corporation has either current earnings and profits (meaning earnings and profits in the current year) or has accumulated earnings and profits. If the dividend is neither covered by current nor accumulated earnings and profits, then the distribution will be treated first as basis reduction to the recipient and, after basis is recovered in full, the remainder as capital gain.

Over the years, a now widely held view has grown inside the tax world to explain this dividend limitation. In general, the explanation is that there cannot be dividend income to shareholders unless the distributing corporation has been profitable. If the corporation has not been profitable, the shareholder must be receiving something in the nature of a return of his investment or a profit on his investment; such receipts are not taxed as ordinary income.

It is my position that we would advance the cause of rationality, simplicity, and harmony in taxation by repealing outright the dividend limitation. What follows are some thoughts in support of

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repeal.

Begin with the history of the limitation itself. The major developments are contained in two pieces of legislation. The first dates back to 1916. A provision was enacted to the effect that absent corporate earnings and profits registered after March 1, 1913, a distribution to shareholders is not to be treated as ordinary dividend income. One might think that this supports the general understanding I stated at the outset. The record, however, suggests that the center of attention in the legislature was on the time factor. Congress, in brief, did not want to have the experience of corporations prior to the effective date of the individual income tax — March 1, 1913 — count in ascertaining what distributions are taxable as dividends. For this reason the statute as amended referred to the earnings and profits position of corporations after March 1, 1913.

The second major development occurred in 1936. Congress then distinguished between accumulated earnings and profits (or accumulated deficits) and current earnings and profits. One might conclude that this refinement also indicated the legislators shared the tax society's common understanding of the limitation. Once again, the record seems to reveal a different focus. In 1936, a tax on the undistributed income of corporations was enacted. A problem was presented by a deficit corporation that had earnings and profits in the current year. If it distributed an amount covered by the current earnings and profits, but still had a deficit after the distribution, did it distribute its earnings and profits in view of the fact that it ended the year with a deficit? Congress enabled the corporation to escape the new tax by allowing it to take into account any distribution out of current earnings and profits. The aim of Congress in all this was narrow and associated with the tax on undistributed profits. Thus, history shows that little attention was paid to the question why a general limitation on dividend income is sensible for a tax on income — particularly a tax on the income of individuals.

Apart from the historical record, there is support for the position that the general limitation is not in harmony with the basic structure of our tax law. Reflect on distributions by corporations, putting aside the limitation on dividends. The law divides these distributions into two major categories. One consists of payouts usually referred to as a dividend, by which we mean a return on the investment (or basis) that a shareholder has in his shares. The other consists of distributions by the corporation which we think of as cashing out some or all of the stockholder's investment in his shares. The shareholder is regarded as though he had sold part or all of his shares in the corporation. The most common example of this pattern is a substantially disproportionate redemption — that is, a redemption that leaves the shareholder with a percentage of the stock substantially smaller than the percentage he owned before the redemption took place. Another illustration is a partial liquidation of the corporation in the form of a corporate contraction — that is, a transaction in which the corporation reduces its trade and business activities to a significant extent and either (1) thereby generates cash and then makes a distribution of the cash to the shareholders, or (2) makes a distribution in kind of the unwanted assets.

On the basis of this distinction between pay-outs which are in the nature of sales to the corporation and pay-outs in the nature of dividends to those invested in the shares, there is no compelling reason to impose a limitation on the taxable treatment of the dividends. Why so? As I see it, the person who invests in shares is not making an investment in the corporate position. For example, suppose an individual buys shares of General Motors stock on the market, while sometime later the company declares and pays a dividend of a dollar a share. From the individual's point of view, that dividend is a return on investment in the General Motors stock. The average investor would think it odd to inquire whether General Motors has current earnings and profits or past earnings and profits. Looking at the circumstances of this distribution, it is enough that the individual is assured it does not represent a substantially disproportionate reduction in his interest in General Motors and it does not reflect a payment associated with a significant contraction in a trade or business being conducted by General Motors. Whether the corporation has earnings and profits should be irrelevant in determining the individual's taxable income in the supposed situation.

Repeal of the dividend limitation, by and large, would not have jarring effects on shareholders. I could conceive of a few exceptions to this proposition. It should be remembered, however, that almost every change that takes place in the taxation of corporations or shareholders might be jarring to some participants. My general assertion here is that, all things considered, this change would rate very low on a scale of upset to taxpayers.

While my proposed change is simple, the existing limitation results in great complexities and difficult issues. Notably, the two prongs of the present test (either current earnings and profits or accumulated earnings and profits, which both lead to ordinary income treatment of dividends) have never fit together well; and there is no way of making them do so. To illustrate, take a corporation that has a very large accumulated deficit. This year is an absolutely banner one for the company, but the expectation is that next year it will again lose money or, at best, break even. Think of the planning that is invited. If the corporation makes a distribution to shareholders this year (the banner earnings year) the payout will be taxed to the shareholders as ordinary income. If instead it holds up paying a dividend until next year — and aggregates the profits of this banner year with the deficit that had already been accumulated, still leaving the company with a deficit — the distribution to shareholders will be subject to the limitation on dividend income. What position will the shareholders be in? They will be treated as having a return of basis and then capital gain rather than ordinary income. The connection between the two prongs of the limitation invites game-playing, and the strategy is unseemly.

Moreover, the limitation on dividend income necessarily calls for generating a vast host of rules. Let me quickly run through four or five illustrations, keeping in mind that many more puzzles could readily be added to the list.

The starting point is to solve the basic question of how the rules for determining earnings and profits relate to the rules for computing taxable income or deductible loss. To what degree are we to be bound by the same accounting rules in computing taxable income or loss and in computing the positive or negative earnings and profits of a corporation? Every time an accounting rule or convention is used in calculating the profit or loss of the corporation for purposes of the corporate income tax, we might need to know whether the same rule or convention is to be used in computing the earnings and profits of that corporation.

Think of a typical corporate redemption. Let us assume that one shareholder is totally redeemed. Assume also that at the time of the redemption the corporation has paid-in capital, an earned surplus, and a large amount of unrealized appreciation on its assets. Dollars are distributed by the corporation to the redeemed shareholder. To what extent do these dollars come out of paid-in capital, out of the earned surplus, and out of the unrealized and unrecognized appreciation in the assets of the corporation? This question has troubled the tax system for many decades.

Take the case of a corporate separation, where one corporation is divided up pursuant to a procedure that qualifies as a spin-off, split-off or a split-up. The accumulated earnings and profits or accumulated deficit of the intact corporation then must be divided between the various corporations that emerge as a result of the corporate restructuring. But it is unclear whether that division should be along the lines of the net asset values in the various corporations, or the aggregate net basis of the assets that go into the corporations, or the prior profitability of the operations put into the corporations, or some combination of these three different concepts.

Take corporate acquisitions, and focus on a corporation that is very successful, having large earnings and profits. It is acquired by a corporation with an even larger accumulated deficit. Under these circumstances, do the accumulated earnings and profits of the profitable corporation disappear? Or do they go over to and survive in the corporation with the deficit? Now reverse the transaction, so that the deficit corporation is acquired by the profitable entity. Can the profitable corporation offset its accumulated earnings and profits with the deficit of the corporation it has acquired? These are very troublesome issues.

Let me complicate the matter even more. Suppose an acquisition qualifies as a tax-free reorganization. The consideration given in the transaction consists of shares in the acquiring corporation and some boot in the form of cash. Assume that the boot is in the nature of a dividend. Which corporation is to be considered in deciding whether there are current earnings and profits or accumulated earnings and profits to cover the dividend-like boot? Do we look at the earnings and profits of the acquired corporation or of the acquiring corporation or a combination of the two?

Turning to a more common type of case, suppose a corporation has an accumulated deficit going into the current year, which happens to be profitable. Further suppose that dividends are distributed this year, but in the aggregate they are in excess of the earnings and profits for the year. During the year, shares have changed hands many times. At some times it looked as though the corporation would be very profitable for the whole year, while at other times it looked as though the profit would be modest. Which of the numerous shareholders who held shares only for part of the year will qualify for being protected by the limitation on dividend income?

In a nutshell, there are a multitude of difficult problems that have to be resolved in defining earnings and profits for purposes of operating the limitation on dividend income. To make matters worse, this is one area in tax law in which there is no statute of limitations at work. If there is a situation in which shareholders of a corporation are claiming that recent dividends to some extent are protected by the limitation, it might be necessary to dig into the corporate history to trace the accumulation of earnings and profits. This might require running through all the redemption transactions, all the acquisition transactions, and all the corporate division transactions in which the corporation was involved. In doing so, one has to play by the rules that were then in force at the time the division, the acquisition, the redemption or other event took place. What a marvelous job for accountants!

At this point I must reveal that a Lexis print-out I now have in my hand shows that the term "earnings and profits" is used in the Code in well over 200 places other than in section 316 — which prescribes the limitation on dividend income.[1] And so you might rightfully ask this question: if we do away with the limitation on dividend income, will we not somehow torpedo these other provisions? After checking into each reference, I have concluded, with one or two possible exceptions involving foreign income (and I am not sure about these), that it would be possible to abolish the limitation on dividend income without in any way undermining the other provisions that make use of an earnings and profits concept. Indeed, I would like to push this conclusion a step further. By doing away with the limitation, we likely would be in a position to have more appropriate provisions in some of the other sections — provisions that are more responsive in dealing with the problems that gave rise to the particular statutory enactments.

I am aware that the topic for this conference was thought to be timely because Congress is about to consider proposed new legislation bearing on fundamental relationships in the taxation of corporations and shareholders.[2] It is therefore germane to inquire: why talk about the limitation on dividend income at this time? The answer is that the proposed new legislation would make some rather far-reaching changes in how earnings and profits are defined for purposes of the dividend limitation. All of these changes move in the direction of defining earnings and profits not in a way that is grounded on the notion of taxable income, but on a notion of income in some economic sense of the concept.

To illustrate: consider a corporation that is making significant use of the accelerated cost recovery system. As a result it is able to eliminate its current earnings and profits (or at least hold them down to a very low level). Assume further that it has no accumulated earnings and profits. Thus, it is in a position to make distributions of dividends which will not be taxed as ordinary income. You can see why those who are looking for errors or misguided provisions in the Code might well argue that a change is needed in the definition of earnings and profits for purposes of the dividend limitation. Such a change would expand the definition of earnings and profits. For example, the difference in amount between ordinary depreciation deductions and accelerated cost recovery deductions would be added

1. I.R.C. § 316 (1982).

2. Deficit Reduction Act of 1984 (Tax Reform Act of 1984), Pub. L. No. 98-369, 98 Stat. 494 (1984).

into earnings and profits. Take another illustration: if the corporation is reporting the sale of an appreciated asset on the installment basis, under the enlarged definition the corporation in the year of sale would be required to pick up in its earnings and profits (but not in its taxable income) the full amount of profit on that sale, thereby lessening the force of the limitation. By shifting the definition from taxable income to a version of economic income, fewer dividends will come under the limitation and hence be exempt from all ordinary income tax.

On initial impression this modification might seem sound. But let us go back to those other provisions in the Code that deal with earnings and profits. Many of them, indeed some central ones, are handling a large problem that is unrelated to the dividend limitation. The problem might best be grasped by focusing on transactions between corporations that are in the same corporate empire. The corporations may be filing consolidated returns or separate returns may be being filed by a parent and a completely owned subsidiary. The subsidiary pays a dividend to the parent, or inside of the consolidated returns groups a dividend is paid by one corporation to another.

In these situations we might want to avoid imposing a double tax at the corporate level on the same income. But we likewise, might not want these dividends to reduce tax at the corporate level. In general, the earnings and profits notion has been utilized to accomplish these goals. It should be apparent that for these purposes the relevant definition or concept of earnings and profits is linked to taxable income. Since the object is to prevent double taxation or prevent something from escaping tax, the yardstick ought to be based on taxable income and not on some measure of economic income.

This point is important in assessing the proposed legislation. If we drastically change the definition of earnings and profits for purposes of the limitation on dividend income, we eventually will end up not with one concept of earnings and profits, but two widely different concepts — one for purposes of the dividend limitation and another for purposes of various inter-corporate transactions, such as those taking place within the same corporate empire.

Earlier, I emphasized that the earnings and profits limitation is already extremely complicated. We seem to be headed in the direction of having a second earnings and profits notion, equally complicated, but applied in different situations. There is, however, an easy way out of this trap. It is to adopt my proposal to repeal the dividend limitation altogether and then address specifically the problems encountered in certain inter-corporate transactions, such as those within the same corporate empire. We would end up with a single earnings and profits notion — a concept that is targeted to the specific problems that strongly call for attention. Perhaps we might find that in trying to prevent double corporate taxation, it is better to abandon the earnings and profits notion and build on some other principle, such as adjusting the basis of assets.

I must acknowledge that my proposal might produce hardships in some situations. It may be prudent to make an exception in limited cases. Let me quickly describe three of them to convey the gist of what I have in mind.

Suppose the four of us on the panel decide to form a corporation, believing the company will need $400,000 of equity capital. We each put in $100,000. Six months later it turns out the corporation doesn't need $400,000; $200,000 will do the trick. So $200,000 is returned to us, divided among the four in proportion to our holding of shares. Where there has been an overcommitment of capital to the corporation and the excess capital is returned within a relatively brief time to the shareholders who contributed it, some kind of relief mechanism might be in order.

Assume that a corporation declares a dividend under some mistaken assumption about the facts. Perhaps we should allow the dividend to be rescinded and returned to the corporation without imposing ordinary income treatment on the shareholders who received it.

Troubling, although important, are some corporations that are primarily mineral operations. In effect, they are in the process of liquidating over a period of time by virtue of not replacing their mineral resources as they become depleted. In that case, the problem might be handled by allowing some kind of set-off against dividends in order to reflect the fact that the depletion reserve, so to speak, is being distributed to the shareholders.

But these are relatively minor matters. They do not, by any means, undercut my major proposition that the dividend limitation should be repealed.

Before ending, I want to present some figures that bolster my case. I asked our law librarian to ascertain how many pages of the Commerce Clearing House Standard Federal Tax Service[3] are devoted to section 312(a),[4] which defines the basic concept of earnings and profits, and how many to section 316,[5] which prescribes the dividend limitation. She counted fifty-seven pages given over to 312(a) and 111 pages on 316. I then asked her to query Lexis on how many

3. 1984 STAND. FED. TAX REP. (CCH), Vol. 1-10.
4. I.R.C. § 312(a) (1982).
5. I.R.C. § 316 (1982).

articles and comments have been published between 1954 and the present time on these two sections. It turns out there were fifty-four articles and comments under section 312 and a total of 128 under section 316(a). From these figures you might get some sense of the magnitude of the complexities that we now face. Finally, I asked her to find out how many cases have involved sections 312 and 316(a). It appears there are 205 cases for 312 and 1395 cases for 316(a) as of the week before this conference began. I am not sure whether these figures represent cases under the two sections or merely citations to them — nor did I have time to check this out.

But I do have one figure ready at my fingertips. The last time I taught my course in taxation of corporations and shareholders, there were twenty-seven sessions, each running an hour and five minutes. One of those sessions was devoted entirely to the limitation on dividend income and its ramifications. I did resent having to give up 1/27th of my allotted time to such an unworthy cause.