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Federal Tax ADVISORY ■

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Stock Dividend Foot Faults

Recently the Treasury issued proposed regulations for Section 305. The proposal was prompted by Section 6045B, enacted in 2008 and effective only under regulations requiring the issuer of stock to provide basis reporting. A stock dividend will always have basis consequences, whether it is taxable or not. Unfortunately, the proposal does not resolve any of the long-standing uncertainties about Section 305.

Affirmative Use

As the title suggests, usually taxpayers want Section 305(a) to apply so that a stock distribution is not taxable. The classic case is the pro rata distribution of common stock on the only class of common, which is not taxable. That is not as typical an event as it once was, when it was used as a method to inflate the total trading value of corporations (a purpose now served by spinoffs).

But Section 305(b) lists several ways that a stock distribution can be taxed as if it were a dividend paid in cash equal to the value of the stock. The first is when stockholders are given a choice to take more stock or cash. That can be a useful tool when it is desirable to move earnings and profits up a chain of corporations (usually foreign) without actually paying a dividend. The lower-tier subsidiary can give its parent the choice of receiving cash or more stock, and the parent elects more stock. That can move more earnings up to the parent.

Disproportionate Distributions

The principal reason why a stock distribution can be taxable is that it can cause a shift in the proportionate ownership of the corporation among groups or classes of shareholders: the additional shares reflect real additional value. This possibility presents several grounds for confusion about stock dividends.

First, a case that might appear to involve a disproportionate stock dividend does not. Suppose the corporation makes a pro rata distribution of common on the only class of common when the corporation also has preferred stock outstanding. Does that mean that the common shareholders as a group increased their proportionate interest? No. They still own all of the common interests, which have not increased in size relative to the preferred. The stock dividend is not taxable.

But if the distribution of stock were the other way around—more preferred to the holders of preferred—then it would be taxable because the preferred class would have increased its interest in the assets of the corporation by the preference of the additional shares.

Second, a stock distribution to some shareholders and a cash distribution to other shareholders can both be taxable even if both classes of stock are common. For example, suppose a corporation pays a pro rata stock dividend on class A common in year 1 and a regular cash dividend on class B common in year 2. The stock dividend will be taxable because the regulation presumes a linkage between the two events if they occur within 36 months of each other. Therefore, the stock dividend is treated like it was an alternative to a cash dividend.

Third, stock rights are treated as stock in Section 305. Convertible debt is a stock right. That means that normal interest payments on convertible debt can be treated as if they were cash dividends paid on stock. In turn, that means that the rule described immediately above can apply if within 36 months the corporation makes a stock distribution on some other class of stock.

Fourth, any distribution of stock that is preferred will be taxable. Therefore, it is very important to know what stock is preferred. Preferred stock must participate, but it is not clear exactly how it must participate. Therefore, taxpayers may be able to modify the characteristics of preferred and avoid this rule.

In conclusion, any corporation planning to make a stock distribution should carefully review the Section 305 regulations—because its application can be unexpected.

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