

TAX LETTER

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Earnings and profits and Redemption of stocks

Earnings and Profits (E&P).

Most long-existing, profitable C corporations would have large amount of E&P, even if they are currently unprofitable. All distributions they make to their shareholders will be dividends, because there is a large sum of E&P from which to pay dividends.

But it may be possible to eliminate the E&P "layer" when either (1) the account is not so large, or (2) it can be reduced by a large distribution to some other shareholders. If E&P is a return of capital. This means that the receiving shareholders have no income at all to the extent of their respective stock basis on which the distributions were paid.

Illustration (1) : A and B each owns 50 shares of Corporation C, which has E&P of \$50. Corporation C redeems B's stock for \$50 and reduces its E&P by B's ratable share, to \$25. Thereafter, a distribution of \$30 to A would be a dividend of \$25 and a return of capital of \$5 (assuming A had at least \$5 basis in the Corporation C stock).

Redemptions.

Redemptions that are treated as distributions under IRC Sec. 301 reduce E&P dollar for dollar, but redemptions that are treated as sales (as in the Illustration) affect E&P in a special way. IRC Sec. 312(n) (7) says redemptions shall not reduce the corporate E&P by more than (1) the amount "properly chargeable to earnings and profits," and (2) the related stock's ratable share of the E&P. The legislative history and the JCT explanation of the 1984 legislation adopting IRC Sec. 312(n) (7) stated that the reduction shall not exceed the amount of the redemption price. While helpful, these guidelines do not answer all of the questions.

What is the amount "properly chargeable," before you get to the ratable share limit? That requires a decision whether the redemption price first reduces paid in capital before it reduces E&P. Before Rev Rul 95-71, Rev Rul 82-72 said that the total redemption price should first be allocated to capital, then the balance to E&P, without limit. However, the '84 Conference Report contained an example that reverses that approach.

Illustration (2) : A corporation redeemed an entire class of stocks for \$140,000. This class of stock had \$100,000 in par value and \$200,000 in issue price (the capital), and a ratable share of E&P of \$120,000. According to Rev Rul 82-72, the entire reduction may go to capital and none to E&P. However, the example in the 1984 legislation report allocated 2/3 of the E&P to the class of stock which were redeemed on the basis of dividend preferences (they were both common classes) and reduced the entire E&P account by 2/3 (\$80,000) before reducing the capital account by \$60,000.

This approach indicated that the amount of the redemption price "properly chargeable" to E&P, insofar as a possible alternative charge to capital is concerned, is 100% of the redemption price, up to the stock's ratable share of E&P not to exceed, as further the full value of the redemption price.

There is no other law on what is the ratable share, as between classes. However, the Conference report indicated that nonparticipating, nonconvertible preferred has no share in the E&P, except for dividend arrearages.

Conclusion.

If you want to reduce a C corporation's E&P by the largest amount through redemption, you should redeem the class that has the largest ratable share of the E&P, which generally should not be the straight preferred stock, and generally should be the class having the largest claim on current distributions.