Property vs. cash distributions from your corporation

Have you ever thought about distributions of property dividends (rather than cash dividends) from your corporation? In some situations, it makes sense to distribute property in lieu of cash for a variety of reasons. However, before you make the decision as to the form of any distributions from your company, you should consider the various tax consequences of such distributions.

A corporation can make a distribution of a "dividend in kind" — which is a property distribution. For such purposes, a distributing corporation's stock and rights for such stock acquisition are not considered to be property. Dividend distributions in these forms are not treated as income that is taxable to the corporation's shareholders, with some important exceptions (e.g., distributions made instead of money; certain distributions made on preferred stock; distributions that are disproportionate; etc.).

A whole host of items can form the basis for your company's next property dividend:

- bonds issued by the government;
- real property;
- the distributing corporation's bonds;
- another corporation's bonds;
- assumption of the indebtedness to a third party of a shareholder;
- transferable vouchers enabling shareholders to receive company products or corporate services discounts;
- promissory notes from customers or other corporate asset purchasers;
- accounts and bills receivable;
- issued transferable vouchers for transportation, by an airline company;
- acquisition options for another corporation's stock; and
- rare coins (e.g., coins having a value that exceed their value as legal tender).

When a corporation distributes property that has increased in value, the corporation will recognize gain, for tax purposes, as if it had sold the property to the shareholder at the property's fair market value. However, the corporation recognizes no loss on distributions of property that have decreased in value. So it you're trying to get rid of property that is not much value to your company anyway, unfortunately, you can't get the added benefit of a loss deduction in planning a property dividend. The distribution amount that is received by a shareholder will be equal to the property's fair market value — decreased by any liabilities that the property is subject to or by any liabilities that the shareholder assumes.

Caution. For shareholders who are not corporations: according to the Tax Court, if a corporation assumes the liability of its shareholder, then at the time of liability assumption the shareholder has a dividend. The shareholder cannot assert a decrease to zero of the dividend due to secondary liability on his or her part. However, the Eighth Circuit has held that when there is a decrease in the shareholder's liability from primary to secondary, there can be no objective assessment of the shareholder's economic benefit so that the shareholder is treated as having no dividend until the corporation pays the debt.

The distribution amount is taxed as a dividend to the extent the corporation has enough earnings and profits in order to cover the distribution. Should the property's value (decreased by any debt) be greater than earnings and profits, the excess does not constitute a dividend. Rather, it is a capital return that is not taxable and is applicable first against the shareholder's basis until there is reduction to zero, at that point representing gain that is subject to taxation.

The shareholder’s basis can differ from the corporation’s basis in the same property. The shareholder’s basis in the property that is distributed is equivalent to the fair market value of the property when it was distributed. Debt does not decrease the value for purposes of basis and the shareholder’s basis is a measure of the shareholder’s future gain or loss when the property is sold or deductions for depreciation if, in the possession of the shareholder, the property is depreciable.

Property distribution impacts corporate earnings and profits, which increases from gain which a corporation may recognize and decreases by the greater amount of the basis the corporation has in the distributed property or the property’s value. The earnings and profits reduction decreases by any debt amount to which the property is subject.

Property dividends may make sense in a variety of circumstances, especially if the property can no longer be put to productive use by your business and only a small amount of taxable gain is at risk of being realized on the distribution. If the property’s value is lower than its tax basis, however, a sale followed by a distribution of the cash proceeds may be the better way to go. Please consult the office if you wish to explore the opportunities presented by a possible property dividend in your business situation.