

company, had a deficit in earnings and profits of \$200,000. During that year it made earnings and profits of \$90,000. For that year, however, it had an undistributed personal holding income (determined under section 545 without regard to distributions under section 316(b)(2)) of \$80,000. During such taxable year it distributed to its shareholders \$100,000. The distribution of \$100,000 is a taxable dividend to the extent of \$90,000 since its earnings and profits for that year, \$90,000, exceed \$80,000, the undistributed personal holding company income determined without regard to such distribution.

Example 5. Corporation O, a calendar year taxpayer, is completely liquidated on December 31, 1964, pursuant to a plan of liquidation adopted July 1, 1964. No distributions in liquidation were made pursuant to the plan of liquidation adopted July 1, 1964, until the distribution in complete liquidation on December 31, 1964. Corporation O has undistributed personal holding company income of \$300,000 for the year 1964 (computed without regard to section 562(b) or section 316(b)(2)(B)). On December 31, 1964, immediately before the record date of the distribution in complete liquidation, individual A owns 200 shares of Corporation O's outstanding stock and Corporation P owns the remaining 100 shares of outstanding stock. All shares are equal in value. The noncorporate distributees' allocable share of undistributed personal holding company income for 1964 is \$200,000

200 shares+300 shares×\$300,000.

If at least \$200,000 is distributed to A in the liquidation, then Corporation O may designate \$200,000 to A as a dividend in accordance with paragraph (b)(5) of this section, and, if such amount is designated, then A must treat \$200,000 as a dividend to which section 301 applies. For an example of the treatment of the distribution to Corporation P see paragraph (b)(2)(iii) of § 1.562-1.

Example 6. Corporation Q, a calendar year taxpayer, is completely liquidated on December 31, 1964, pursuant to a plan of liquidation adopted July 1, 1964. No distributions in liquidation were made pursuant to the plan of liquidation adopted July 1, 1964, until the distribution in complete liquidation on December 31, 1964. Corporation Q has undistributed personal holding company income of \$40,000 for the year 1964 (computed without regard to section 562(b) or section 316(b)(2)(B)). On December 31, 1964, immediately before the record date of the distribution in complete liquidation, Corporation Q has outstanding 300 shares of common stock and 100 shares of noncumulative preferred stock. Corporation Q's articles of incorporation provide that the preferred stock is entitled to dividends of \$10 per share per year. Of Corporation Q's stock, individual B owns 200 shares of the common stock and 50 shares of

the preferred stock, and Corporation R owns all remaining shares. All of the common shares are equal in value, and all of the preferred shares are equal in value. No dividends had been paid on the preferred stock during the year 1964. Of the \$40,000 of undistributed personal holding company income, \$1,000 must be allocated to the preferred stock because of the rights of the holders of such stock, under Q's articles of incorporation, to receive that amount in dividends for the year 1964. The noncorporate distributees' allocable share of undistributed personal holding company income for 1964 is \$26,500.

50 preferred shares+100 preferred shares×\$1,000+200 common shares + 300 common shares×\$39,000

If at least \$26,500 is distributed to B in the liquidation, then corporation Q may designate \$26,500 to B as a dividend in accordance with paragraph (b)(5) of this section, and, if such amount is designated, then B must treat \$26,500 as a dividend to which section 301 applies.

Example 7. In 1979, a deficiency of \$46,000 in the tax on real estate investment trust taxable income is established against corporation R for the taxable year 1977, based on an increase in real estate investment trust taxable income of \$100,000. Corporation R complied with the provisions of section 860 and in December 1979 distributed to its stockholders \$100,000, which qualified as "deficiency dividends" under section 860. The distribution of \$100,000 is a taxable dividend. It is immaterial whether corporation R is a real estate investment trust for the taxable year 1979 or whether it had accumulated or current earnings and profits in 1979. See section 316(b)(3).

(Sec. 860(l) (92 Stat. 2849, 26 U.S.C. 860(l)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); and sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6625, 27 FR 12541, Dec. 19, 1962; T.D. 6949, 33 FR 5519, Apr. 9, 1968; T.D. 7767, 46 FR 11264, Feb. 6, 1981; T.D. 7936, 49 FR 2105, Jan. 18, 1984]

§ 1.316-2 Sources of distribution in general.

(a) For the purpose of income taxation every distribution made by a corporation is made out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits. In determining the source of a distribution, consideration should be given first, to the earnings and profits of the taxable year; second, to the earnings and profits accumulated since February 28, 1913, only in the case where, and to the extent that,

§ 1.316-2

26 CFR Ch. I (4-1-15 Edition)

the distributions made during the taxable year are not regarded as out of the earnings and profits of that year; third, to the earnings and profits accumulated before March 1, 1913, only after all the earnings and profits of the taxable year and all the earnings and profits accumulated since February 28, 1913, have been distributed; and, fourth, to sources other than earnings and profits only after the earnings and profits have been distributed.

(b) If the earnings and profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings and profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. See § 1.316-1. If the distributions made during the taxable year consist only of money and exceed the earnings and profits of such year, then that proportion of each distribution which the total of the earnings and profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings and profits of that year. The portion of each such distribution which is not regarded as out of earnings and profits of the taxable year shall be considered a taxable dividend to the extent of the earnings and profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings and profits accumulated since February 28, 1913, and the actual earnings and profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made.

(c) The provisions of the section may be illustrated by the following example:

Example. At the beginning of the calendar year 1955, Corporation M had \$12,000 in earnings and profits accumulated since February

28, 1913. Its earnings and profits for 1955 amounted to \$30,000. During the year it made quarterly cash distributions of \$15,000 each. Of each of the four distributions made, \$7,500 (that portion of \$15,000 which the amount of \$30,000, the total earnings and profits of the taxable year, bears to \$60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, \$7,500 and \$4,500, respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and before the taxable year, as follows:

Distributions during 1955		Portion out of earnings and profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913, and before the taxable year	Taxable amt. of each distribution
Date	Amount			
March 10	\$15,000	\$7,500	\$7,500	\$15,000
June 10	15,000	7,500	4,500	12,000
September 10	15,000	7,500	7,500
December 10	15,000	7,500	7,500
Total amount taxable as dividends	42,000

(d) Any distribution by a corporation out of earnings and profits accumulated before March 1, 1913, or out of increase in value of property accrued before March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether before, on, or after March 1, 1913), is not a dividend within the meaning of subtitle A of the Code.

(e) A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of surplus out of which ordinary dividends may be paid. A distribution made from a depletion or a depreciation reserve based upon the cost or other basis of the property will not be considered as having been paid out of earnings and profits, but the amount thereof shall be applied against and reduce the cost or other basis of the stock upon which declared. If such a distribution is in excess of the basis, the excess shall be taxed as a gain from the sale or other disposition of property as provided in section 301(c)(3)(A). A distribution from a depletion reserve based upon discovery value to the extent that such

reserve represents the excess of the discovery value over the cost or other basis for determining gain or loss, is, when received by the shareholders, taxable as an ordinary dividend. The amount by which a corporation's percentage depletion allowance for any year exceeds depletion sustained on cost or other basis, that is, determined without regard to discovery or percentage depletion allowances for the year of distribution or prior years, constitutes a part of the corporation's "earnings and profits accumulated after February 28, 1913," within the meaning of section 316, and, upon distribution to shareholders, is taxable to them as a dividend. A distribution made from that portion of a depletion reserve based upon a valuation as of March 1, 1913, which is in excess of the depletion reserve based upon cost, will not be considered as having been paid out of earnings and profits, but the amount of the distribution shall be applied against and reduce the cost or other basis of the stock upon which declared. See section 301. No distribution, however, can be made from such a reserve until all the earnings and profits of the corporation have first been distributed.

§ 1.317-1 Property defined.

The term *property*, for purposes of part 1, subchapter C, chapter 1 of the Code, means any property (including money, securities, and indebtedness to the corporation) other than stock, or rights to acquire stock, in the corporation making the distribution.

§ 1.318-1 Constructive ownership of stock; introduction.

(a) For the purposes of certain provisions of chapter 1 of the Code, section 318(a) provides that stock owned by a taxpayer includes stock constructively owned by such taxpayer under the rules set forth in such section. An individual is considered to own the stock owned, directly or indirectly, by or for his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and by or for his children, grandchildren, and parents. Under section 318(a)(2) and (3), constructive ownership rules are estab-

lished for partnerships and partners, estates and beneficiaries, trusts and beneficiaries, and corporations and stockholders. If any person has an option to acquire stock, such stock is considered as owned by such person. The term *option* includes an option to acquire such an option and each of a series of such options.

(b) In applying section 318(a) to determine the stock ownership of any person for any one purpose—

(1) A corporation shall not be considered to own its own stock by reason of section 318(a)(3)(C);

(2) In any case in which an amount of stock owned by any person may be included in the computation more than one time, such stock shall be included only once, in the manner in which it will impute to the person concerned the largest total stock ownership; and

(3) In determining the 50-percent requirement of section 318(a)(2)(C) and (3)(C), all of the stock owned actually and constructively by the person concerned shall be aggregated.

[T.D. 6969, 33 FR 11999, Aug. 23, 1968]

§ 1.318-2 Application of general rules.

(a) The application of paragraph (b) of § 1.318-1 may be illustrated by the following examples:

Example 1. H, an individual, owns all of the stock of corporation A. Corporation A is not considered to own the stock owned by H in corporation A.

Example 2. H, an individual, his wife, W, and his son, S, each own one-third of the stock of the Green Corporation. For purposes of determining the amount of stock owned by H, W, or S for purposes of section 318(a)(2)(C) and (3)(C), the amount of stock held by the other members of the family shall be added pursuant to paragraph (b)(3) of § 1.318-1 in applying the 50-percent requirement of such section. H, W, or S, as the case may be, is for this purpose deemed to own 100 percent of the stock of the Green Corporation.

(b) The application of section 318(a)(1), relating to members of a family, may be illustrated by the following example:

Example. An individual, H, his wife, W, his son, S, and his grandson (S's son), G, own the 100 outstanding shares of stock of a corporation, each owning 25 shares. H, W, and S are each considered as owning 100 shares. G is