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# Income and Gift Tax Treatment of a Waiver of Rights to Future, Undeclared Dividends by a Corporate Shareholder

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# NOTES

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## I. INTRODUCTION

Ownership of corporate stock generally entitles a shareholder to receive a portion of any dividend declared by the corporation. If a dividend is declared and payment is received by a taxpayer, he is taxable on that dividend income.[1] A shareholder may decide, however, to waive his rights to dividends that have not yet been declared.

Waiver of the right to future undeclared dividends raises questions concerning the resulting income and gift tax consequences. Relying upon a number of tax doctrines, the Internal Revenue Service (Service) has often determined that the waiving shareholder constructively received the dividend as income and made a gift of it to the corporation or to other shareholders. In reviewing the validity of this treatment of dividend waivers, courts have been faced with the problem of balancing competing policy considerations: the encouragement of growth and stability in business through the recognition of transactions entered into for bona fide business purposes versus the prevention of diversion of income and shifting of tax liability within families by striking down as shams transactions that

1. Congress has consistently viewed corporate stock as income-producing property and has sought to tax corporate distributions of earnings and profits to shareholders with respect to their stock as income to the shareholders. Various congressional enactments have taxed dividends as income since 1913. The Internal Revenue Code of 1954 specifically includes dividends as income in § 61. Sections 301-318 provide for taxation of corporate distributions to shareholders out of post-1913 earnings and profits.

appear to have been entered into for tax avoidance purposes. In attempting to strike this balance, the courts and the Service have left the law concerning dividend waivers in a state of confusion. An analysis of the cases and revenue rulings considering the tax treatment of dividend waivers reveals that the tax ramifications of these transactions have not been clearly delineated. Also, definitional and technical problems exist in the method of analysis presently applied to determine the proper tax characterization of a dividend waiver.

As a result of this confusion, the taxpayer who waives a future dividend has little guidance in determining the proper tax characterization of the transaction. This Note will attempt to set forth and analyze the present state of the law concerning dividend waivers. After determining that this law gives taxpayers few standards for determining the proper tax characterization of a dividend waiver, the Note concludes that analogous areas of tax law must be examined for guidance. Finally, the Note identifies and discusses several analogies that might be helpful to a taxpayer faced with a dividend waiver problem.

## II. Income Tax Treatment of Dividend Waivers

### A. *Internal Revenue Service Rulings*

The Service has issued several revenue rulings that directly address the proper tax treatment of a shareholder's waiver of his right to receive future dividends. In Revenue Ruling 45[2] the Service examined a majority shareholder's waiver for a specified period of time of all right, title, and interest in future undeclared dividends. Taxpayer asserted that the waiver was needed to increase the corporation's capital surplus to an amount sufficient to meet the legal requirements of a new business venture. No family or business relationship existed between the waiving majority shareholder and minority shareholders, and the declaration and payment of any dividend to minority shareholders would not increase the waiving shareholder's interest in the remaining or future surplus of the corporation. The Service accepted taxpayer's reason for the waiver as a bona fide business purpose and ruled that any dividend payments to minority shareholders would not result in income to the waiving shareholder. The Service further stated that the corporation would not realize any income because of the waiver.[3]

The opposite result was reached in Revenue Ruling 56-431,[4] in

2. 1953-1 C.B. 178.
3. *Id.*
4. 1956-2 C.B. 171.

which the Service refused to recognize the waiver by a majority shareholder of the right to receive his pro rata share of any future dividends paid by the corporation. The waiving shareholder's pro rata share of the dividends were to be paid in the form of increased dividends to the minority shareholders. Several of these minority shareholders were the taxpayer's relatives; the remainder were employees of the corporation. The Service held that the primary purpose of the waiver was to benefit the taxpayer's relatives.[5] It also found the alleged business purpose for the waiver—the payment of a larger dividend to minority shareholders who were key employees in order to maintain their good will—to be incidental to the intended benefit to the relatives. The Service thus ruled that the waiving majority shareholder realized income to the extent of the dividends waived. Revenue Ruling 56-431 expressly distinguished Revenue Ruling 45, noting the lack of any family or direct business relationship between the majority and minority shareholders and the existence of bona fide business reasons as the sole purpose for the waiver in the earlier situation.[6]

These two rulings typify the factual settings in which the Service's treatment of a dividend waiver is clear. On the one hand, the taxpayer will not be taxed if there are bona fide business reasons for the waiver and the waiver does not result in any substantial benefit to his relatives. On the other hand, the waiving shareholder will be subject to a tax on the waived dividends if the waiver substantially benefits his relatives and no bona fide business purpose exists.

Uncertainty remains, however, concerning the tax consequences of a dividend waiver, the facts of which fall somewhere between these two situations. In addition, ambiguities exist concerning what constitutes a sufficient bona fide business purpose for a dividend waiver, who will be considered "relatives" of the waiving shareholder, and what constitutes a "substantial benefit" to the waiving shareholder's relatives. Examination of more recent revenue rulings reveals that these problems have not been resolved.

In Revenue Ruling 65-256[7] the Service reemphasized the im-

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5. Taxpayer owned 65% of the corporation's stock, and his relatives, including his minor children, owned 25%. Unrelated employees of the corporation owned the remaining 10%. The immediate and long-term working capital requirements precluded payment of large dividends to all the shareholders, and no dividends had been paid since the formation of the corporation. The minority shareholders, most of whom were the taxpayer's relatives, desired to receive a proper return on their investment. The taxpayer's waiver of his rights to any dividends declared up to a specified date enabled the corporation to declare and distribute dividends in substantial amounts to the minority shareholders, without depleting the corporation's working capital. *Id.* at 172.

6. *Id.* at 173.

7. 1965-2 C.B. 85, 86. In Revenue Ruling 71-164, 1971-1 C.B. 108, taxpayer was a

portance of business or family relationships between the waiving and nonwaiving shareholders, the benefit to the family of the waiving shareholder, and the business reasons for the waiver in determining whether a dividend waiver results in constructive income to the waiving shareholder. This ruling did not consider an express waiver of the right to receive dividends; rather, it addressed a transaction in which a majority shareholder of a corporation, pursuant to a merger, agreed to surrender all his stock in exchange for all the shares of a new and separate class of stock in the successor corporation. The Service analogized the transaction to a dividend waiver because the new class of stock was subject to certain dividend limitations.[8] The shareholder in effect waived his rights to some dividends by accepting stock with dividend restrictions rather than demanding shares without restrictions. The Service upheld the waiver, however, emphasizing the absence of a direct business or family relationship between the holder of the restricted shares and shareholders of unrestricted stock.[9] The Service also pointed out that the benefits to be received by the members of taxpayer's family as a result of his acceptance of restricted stock were insignificant[10] and that bona fide business reasons existed for the shareholder's acceptance of restricted stock.[11] Thus the Service held that although

director shareholder who owned a minority interest in the common stock of a bank because of a statute requiring bank directors to own stock in their banks. Taxpayer waived his right to receive part of his share of all dividends paid by the bank. The Service held that taxpayer was not in constructive receipt of dividend income when the bank declared and paid to its majority shareholder, a parent holding company, a dividend in excess of the amount not waived.

Another variation of the dividend waiver is the situation in which all shareholders waive their dividend rights. The Service has held that when all of the shareholders of a corporation waive their rights to all or part of an authorized dividend, the amount so waived is not taxable as a dividend. *See* Berthold v. Commissioner, 12 B.T.A. 1306 (1928), *acq.*, IX-1 C.B. 5 (1930).

8. The provisions for payment of dividends, including the limitations on the first class of shares, as contained in the successor corporation's certificate of incorporation were as follows:

> A dividend may be paid on the class A stock at the discretion of the board of directors provided an equal dividend is paid on the class B stock. If a dividend is paid on the class B stock, the class A shareholders are to receive an equal dividend up to $0.10 per share after which they cannot be paid any further dividends even though further dividends are paid on the class B stock. The class A shareholders may receive a ratable stock dividend in class A stock but cannot receive a stock dividend in class B stock. The class A stock may be converted into class B stock, after 3 years, at the election of the class A shareholders.

1965-2 C.B. at 85.

9. The second class of stock (class B) was held widely by the public. *Id.*

10. Members of taxpayer's family owned only 0.06% of the total capital stock of the successor corporation. *Id.*

11. The bona fide business purposes for which the shareholder agreed to accept the restricted class A shares were to provide an incentive to the shareholders of the other corpora-

the taxpayer's stock was subject to certain dividend limitations, he would not be considered to have constructively received any dividend solely because of the declaration and payment of excess dividends on the unrestricted stock. The Service noted, however, that any significant change in the stockholdings of the surviving corporation resulting in a direct business or family relationship between the holder of the restricted shares and other shareholders was not within the scope of the ruling. Although Revenue Ruling 65-256 addressed the policy considerations relevant to a dividend waiver situation, it failed to add to or clarify the standards that were used to determine the proper tax treatment of a dividend waiver in Ruling 45 or Ruling 56-431.

The Service's most recent statement concerning waiver of dividends came in a 1977 private letter ruling.[12] In this ruling three corporate officers, who owned approximately seventy-five percent of the stock of a corporation, had offered to waive their rights to dividends with respect to their stock in order to preserve the working capital of the corporation while allowing outside investors to receive a fair return on their investments. The Service ruled that for a period of two years the waiver arrangement would not result in taxable income to the corporation or to the waiving shareholders. Again the result seemed to rest on the existence of bona fide business reasons for the waiver and the lack of any familial relationships. The ruling provides no additional guidance, however, to a taxpayer in determining what the Service will consider a bona fide business purpose or a sufficient familial relationship.

### B. *Judicial Treatment:* Bagley v. United States

The principal court case addressing dividend waivers is *Bagley v. United States*,[13] in which a federal district court held that a waiving shareholder was taxable on waived future dividends. In *Bagley* taxpayer owned 49.9% of the stock of a family corporation. The remaining shares were owned by taxpayer's wife, his children from a previous marriage, and his sister. At the direction of taxpayer, the company declared a dividend of twenty dollars per share on all shares except those owned by taxpayer and his wife. This method of distribution resulted in an increase in dividends received by remaining shareholders. The government asserted that taxpayer

tion to agree to the merger, to obtain effective voting control of the merged company, and to preserve a sufficient amount of working capital in the new corporation. *Id.* at 85-86.

12. I.R.S. Letter Ruling 7731004 (April 1977).

13. 348 F. Supp. 418 (D. Minn. 1972).

and his wife had constructively received dividend income. Taxpayer maintained that no dividend had been received, actually or constructively, and that no income should be reported as a result of the transaction.

The district court initially examined the non-pro rata dividend issue, holding it would not automatically reapportion the dividends simply because they were not distributed on a pro rata basis. The court explained that prior cases holding taxpayers liable for income tax on non-pro rata dividends had addressed situations in which a taxpayer received either more than his pro rata share of a distribution or some other economic benefit from the disproportionate distribution. Finding no economic benefit to either Bagley or his wife from the distribution of dividends to other shareholders,[14] the court held that Bagley and his wife had not constructively received any dividends under the economic benefit theory.[15]

Nevertheless, the court looked beyond the economic benefit theory, asserting that closely held corporations must be scrutinized to determine whether familial ties were a motive in structuring the manner and amount of corporate dividends.[16] The court emphasized that when close family ties between shareholders are present, courts must recognize the possibility that gifts might be bestowed on non-waiving shareholders by means of a dividend waiver. Focusing on the substance rather than the form of the transaction, the court found that taxpayer's waiver of his right to receive dividends constituted a gift to his children and sister: by his waiver of dividends Bagley had in effect assigned his right to those dividends to his sister and children.[17] The court cited Revenue Ruling 56-431[18] for the rule that a majority shareholder who waives his right to dividends will be deemed to have received a constructive dividend if minority shareholders are related to him. The court thus held that because Bagley constructively received 49.9% of the total dividend and gave it to his sister and children, he was subject to income tax liability on the constructive dividend. Because of the presence of close familial ties, the court found the absence of economic benefit to Bagley to be immaterial.[19] The court held, however, that Bagley's

14. The court found no economic benefit to taxpayer because the dividend was not in lieu of any regular payments to his children, did not extinguish any moral or legal obligations to them, and did not replace any benefits that he otherwise would have provided for them. *Id.* at 421.

15. *Id.*

16. *Id.*

17. *Id.*

18. *See* notes 4-6 *supra* and accompanying text.

19. 348 F. Supp. at 421.

wife had not received a constructive dividend, noting that she was not the majority stockholder, that she could not set the dividend policy alone, and that the familial ties between her and her stepchildren and sister-in-law were not as great as those of her husband.

### C. *Theoretical Underpinnings of Internal Revenue Service and Judicial Treatment*

In the case and rulings discussed above, phrases such as "constructively received dividend income," "received a constructive dividend," and "realized income" have been used indiscriminately. Neither the Service nor the courts have expressed clearly whether they are applying the constructive receipt doctrine, the constructive dividend doctrine, principles of realization, the assignment of income doctrine, or a combination of any or all of these concepts in their treatment of dividend waivers. Analysis reveals that these doctrines either have been applied improperly or are not appropriate for application to the dividend waiver situation.

The doctrine of constructive receipt in its original form and traditional application is not appropriate for analyzing a waiver of the right to future dividends. This doctrine was developed for determining *when* income should be taxed to a taxpayer who had unqualified and unrestricted access to the income. The purpose of the doctrine is to prevent taxpayers from deferring taxation by refusing to exercise their control over receipt of income that could be immediately reduced to their possession.[20] The underlying policy is that a taxpayer should not have the right to choose the year in which income will be taxable to him simply by refusing to reduce to his possession income that is currently available to him.[21] In substance, the doctrine holds that a taxpayer will be considered to have constructively received income that has been credited to his account or set apart for him in such a way that he may draw upon it without substantial impediment or restriction as to the time, manner, or conditions of payment. The doctrine has been typically applied to find that a cash basis taxpayer constructively received income in the

20. 1 MICHIE'S FEDERAL TAX HANDBOOK ¶ 406 (J. Gibson ed. 40th ed. 1978) [hereinafter cited as FEDERAL TAX HANDBOOK]. For a general discussion of the doctrine of constructive receipt of income, see 1 FEDERALTAX HANDBOOK ¶ 406 and 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 10.01-.18 (rev. 1974). *See also* Hyland v. Commissioner, 175 F.2d 422 (2d Cir. 1949); Ross v. Commissioner, 169 F.2d 483 (1st Cir. 1948); Treas. Reg. § 1.451-2 (1957). For a discussion of the applicability of the constructive receipt doctrine specifically to waivers of the right to receive income, see 2 J. MERTENS, *supra*, § 10.06, and to dividends, *id.* §§ 10.09-.11.

21. *See* 1 FEDERAL TAX HANDBOOK, *supra* note 20, ¶ 406; 2 J. MERTENS, *supra* note 20, § 10.01.

year prior to that in which he actually reduced it to his possession.[22]

The dividend waiver differs from the traditional constructive receipt situation. Until a dividend is declared by the corporation, the waiving shareholder's ability to receive payment and thereby to reduce income to possession is not unqualified and unrestricted. A substantial impediment remains to the shareholder's receipt of the income because the corporation must first declare and make available payment of a dividend. Thus, in the situation of a waiver of rights to future, undeclared dividends, the waiving shareholder cannot have unqualified control over the receipt of the income. To the contrary, he has no rights at all to receive dividends because he has relinquished his rights prior to the declaration of the dividend. In applying the doctrine of constructive receipt to dividend waivers, the Service has distorted the doctrine beyond its intended boundaries. A great distinction exists between a shareholder who simply refuses to pick up a dividend check that has been made unqualifiedly available to him and a shareholder who could not receive a dividend check even if he wanted to because he previously relinquished all rights to any future dividend. Constructive receipt should not be confused with an absolute refusal, relinquishment, or renunciation of a right to receive income. Indeed, courts have recognized that "[i]t is elemental that an individual may refuse to enforce a right, forswear a debt due him, or relinquish a claim. After such action it is equally basic that his debtor retains full possession and ownership of the thing renounced."[23] Thus the constructive receipt doctrine is an inappropriate means of finding a waiving shareholder taxable when a dividend is later declared and distributed.

Similarly, the constructive dividend doctrine cannot be properly applied to a dividend waiver. This doctrine is appropriately applied when a corporation bestows an economic benefit upon a shareholder, but disguises the benefit by calling it something other than a dividend.[24] Typical situations in which constructive dividends may be found include use of corporate property by a shareholder,[25] a sale of property by a shareholder to the corporation at an excessive price,[26] payments made by the corporation to third parties for a shareholder's benefit,[27] and diversion of corporate funds to

22. *Id.*

23. Giannini v. Commissioner, 42 B.T.A. 546, 556 (1940), *aff'd,* 129 F.2d 638 (9th Cir. 1942).

24. *See* 1 J. MERTENS, *supra* note 20, §§ 9.07-.09.

25. *See id.* § 9.07.

26. *See id.* § 9.22.

27. *See id.* § 9.08.

shareholders.[28] Unless the shareholder is relieved of preexisting obligations, it is difficult to find any economic benefit bestowed by the corporation on a shareholder who has relinquished his rights to dividends and who has not received any distribution from the corporation. Even the *Bagley* court found that when a waiving shareholder's relatives received increased dividends as a result of his waiver, he received no economic benefit from the distribution if it was not used to satisfy any moral or legal obligation of the waiving shareholder to those relatives. Nevertheless, the *Bagley* court found the waiving shareholder in that case taxable because of his familial relationship with the nonwaiving shareholders. The court stated that Bagley "received a constructive dividend" and that he "constructively received the dividend and gave it to [his relatives] as a gift."[29] The court's inconsistent language fails to indicate precisely the doctrinal basis used to determine that the taxpayer's waiver resulted in income tax liability.

Another principle of taxation relevant to an analysis of the tax consequences of a dividend waiver is the assignment of income doctrine. The assignment of income doctrine is properly applied to determine *who* is taxable with respect to income. A number of decisions have established the general rule that the tax on the right to receive income cannot be shifted to another taxpayer by a simple transfer of the income.[30] The policy underlying this doctrine is that the power to dispose of income is the equivalent of ownership, and the exercise of that power to cause the payment of income to another is enjoyment and hence realization of the income.[31] If the taxpayer-assignor continues to earn the income and to own the underlying property that produces the income, he should be taxable on that income as fully when he assigns or gives it to someone else in advance of its receipt as he would be if he made the assignment or gift after actually receiving the income. Despite the *Bagley* court's confusing language, the court was apparently applying the assignment of income doctrine. The court's language that the taxpayer and his wife "in essence gave their share of the dividends as a gift to their children"[32] is more consistent with this theory than with either the constructive dividend or constructive receipt doctrine. Because the taxpayer and his relatives owned all of the corporation's stock and

28. *See id.* § 9.09.

29. 348 F. Supp. at 421.

30. *See, e.g.*, Harrison v. Schaffner, 312 U.S. 579 (1941); Helvering v. Eubank, 311 U.S. 122 (1940); Helvering v. Horst, 311 U.S. 112 (1940).

31. Helvering v. Horst, 311 U.S. 112 (1940).

32. 348 F. Supp. at 421.

his pro rata share of the dividends was paid to his relatives as increased dividends, his waiver was in effect an assignment of his share of dividends to those relatives.

Although the result in *Bagley* was arguably correct, proper application of the assignment of income doctrine to dividend waivers would produce inconsistent results. If the waiving shareholder's pro rata share of dividends is distributed to nonwaiving shareholders according to their proportionate stock interests, the waiver has the effect of an assignment of the waiving shareholder's right to dividend income. Theoretically, the result should be the same whether or not nonwaiving shareholders are related to the waiving shareholder because the waiver results in an increased dividend to all nonwaiving shareholders. Yet cases and rulings have made a distinction based upon the family relationships present. The results in these cases have turned upon whether substantial benefits were received by relatives of the waiving shareholder. This distinction is incompatible with assignment of income principles. The result should depend upon whether the nonwaiving shareholders will receive increased dividends, not upon whether they are related to the nonwaiving shareholder. Differing results based on the existence or nonexistence of benefits to relatives are not justifiable under true assignment of income principles.

Another problem arises when the waiving shareholder's pro rata share of dividends is retained by the corporation rather than paid out to nonwaiving shareholders. Under these circumstances, the waiving shareholder cannot be said to have assigned his right to dividends to other shareholders. He has merely relinquished or renounced his right to future dividends. In such a case, not only has there been no assignment of the waiving shareholder's pro rata share of dividends, but there has been no realization of income by any person because the waived dividends remain in corporate solution. Although the waiver may have the effect of increasing the value of the corporation's stock, this increase in value is not taxable as income because it has not been "realized."[33] This realization question does not arise when the waiving shareholder's pro rata share is distributed to the nonwaiving shareholders; when the corporation distributes the dividend, the income is realized. The question then becomes not whether income is realized, but *who* realized it.

33. Within its overall scheme of taxation Congress did not intend to tax as income mere appreciation in the value of assets still in taxpayers' hands. Thus tax liability is incurred only when income is "realized." The Internal Revenue Code does not define this term explicitly, but some type of transaction normally must occur with the result that the taxpayer has something more than he had prior to the transaction. In the case of corporate shareholders, no income is realized by them so long as all profits remain in corporate solution.

Although the doctrines discussed above are not properly applicable to a dividend waiver, they have in fact been utilized, individually or collectively, by the courts and the Service. Application of these doctrines has caused significant confusion concerning the proper tax treatment of dividend waivers. A taxpayer contemplating a dividend waiver must be prepared to untangle this confusion. Since the revenue rulings and case law offer little guidance, taxpayers must look to analogous tax areas in attempting to resolve existing ambiguities. Following an examination of the gift tax consequences of a waiver of the right to receive future undeclared dividends, areas of useful analogy will be explored.

## III. Gift Tax Treatment of Dividend Waivers

A waiver of future undeclared dividends may give rise to gift tax consequences in addition to the income tax consequences discussed in the previous section. Although the *Bagley* court held that the waiving shareholder made a gift to his relatives of his pro rata share of the total dividends paid to nonwaiving shareholders, the opinion did not discuss the possibility of gift tax liability.[34] The gift tax consequences of a dividend waiver were directly addressed, however, by the Tax Court in *Collins v. Commissioner.*[35] The principal issue in the case was whether a shareholder had made a gift to a corporation by waiving her right to preferred stock dividends of $38,000 that were in arrears.[36] In the taxpayer's words, the waiver

34. After holding that Bagley constructively received the waived dividends, the *Bagley* court concluded that since the money finally came to rest in the hands of his relatives, Bagley had made a gift of the dividends. 348 F. Supp. at 421. The court did not discuss, however, the possibility of gift tax liability resulting from this transaction. The only analysis of the tax consequences of the transaction related to Bagley's income tax liability.

35. 1 T.C. 605 (1943).

36. Taxpayer and her three children formed a corporation in 1930 immediately following the death of taxpayer's husband, who at the time of his death was liable for debts in an amount exceeding $180,000. Taxpayer transferred a portion of the property of her husband's estate to her three children, and they in turn transferred the property to the new corporation. Taxpayer also transferred a significant amount of property to the corporation. In exchange for the property the corporation issued twenty-five shares of no par common stock and one thousand shares of six percent cumulative preferred stock to taxpayer and twenty-five shares of no par value common stock to each of the children. These shares constituted all of the corporation's stock, and each share had a single vote. The estate creditors became creditors of the corporation, and when the debts had not been paid by 1933, three years after the formation of the corporation, the creditors demanded that the debts be liquidated. The corporation was able to pay off all demanding creditors within the next three years, but only after obtaining $40,000 in bank loans. The corporation had no accumulated or earned surplus until 1934, and no dividends were paid until after 1936. At the close of 1936, the undeclared dividends in arrears on taxpayer's preferred stock totalled $38,000. At that time taxpayer executed a document in which she waived all rights to the preferred stock dividends in arrears. *Id.* at 606.

was made "because of the indebtedness and prior obligations of [the] company" and because "it is not practicable to declare a dividend . . . since the assets of the company are pledged on account of [the] indebtedness."[37] The Commissioner determined that the taypayer made a gift to the corporation, theorizing that the waiver constituted a voluntary contribution of an equitable property interest having a fair market value of $38,000. This amount, less one exclusion, was therefore deemed subject to gift tax for the year in which the waiver was made.[38] The taxpayer argued that the corporation was organized for the purpose of conserving her husband's estate and paying off his debts without sacrificing assets. She further asserted that she executed the waiver because she realized that the corporation was not in a position to declare dividends on the preferred stock and that her purposes would be served best by permitting the corporation to discharge its debts before having to pay any dividends on the preferred stock.

In resolving the dispute, the Tax Court viewed the taxpayer's right to the dividends as "incomplete and inchoate, at least until the directors saw fit to declare them or without good reason, refused to declare them."[39] The court stressed that gift taxes are imposed upon the transfer of property by gift.[40] Reasoning that "[t]he 'waiver' was of something not yet done which might never be done"[41] and that "[p]rior to the declaration of a dividend, the right of the stockholder to a share of the earnings is not property . . . ,"[42] the court held that in this case no transfer of property by gift to the corporation had occurred within the meaning of the gift tax provisions of the Internal Revenue Code.[43] The Service nonacquiesced[44] in the Tax Court's decision, and the case was settled while on appeal to the United States Court of Appeals for the Third Circuit.

The dissent in *Collins* took the position that taxpayer made a gift to the holders of the common shares by waiving her right to dividends on the preferred shares.[45] The dissent noted that the corporation's net income for the year in which the waiver was made was approximately double the amount of dividends in arrears on the preferred stock and that its earned surplus was sufficient to pay the

37. *Id. See* note 36 *supra*.
38. 1 T.C. at 607.
39. *Id.* at 609.
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.*
44. 1943 C.B. 29.
45. 1 T.C. at 610.

full amount in arrears. The dissent also pointed out that the waiver clearly benefited taxpayer's children and that

> [t]he net result as to the dividends was no different than it would have been if, retaining the stock, she had collected the dividends and given them to her children; or if she had delivered the stock to them and they had collected the dividends; or if she had retained both and passed them to her children at death.[46]

Since taxpayer's children owned seventy-five percent of the common stock, the dissent asserted that taxpayer had in effect made a gift to the corporation and thus a gift to her children of seventy-five percent of the amount of the dividends waived.[47] Questioning the majority's view that the issue in the case was whether a dividend waiver is a transfer of property that can be considered a gift, the dissent emphasized that the *result* ·f the dividend waiver was the same as the result that would have occurred if taxpayer had collected the dividends herself and then given them to her children.

Commentators have stated that the *Collins* case is virtually unique and that in most circumstances the irrevocable assignment of future, undeclared dividends or the waiver of a taxpayer's right to his pro rata share of dividends to be distributed among a group of related shareholders is likely to be treated as a taxable gift.[48] These commentators have not refuted *Collins,* however, by citing any cases holding that a dividend waiver is a gift.[49] They do cite *Hyman v. Commissioner,*[50] in which the Tax Court held that a shareholder's assignment to her husband of her right to dividends was taxable to the shareholder as income to her and as a gift to her husband. The court held the value of the gift to be the amount of dividends that were declared and paid to the assignee during the effective period of the assignment. Relying on this case, these commentators apparently consider a dividend waiver to be equivalent to an assignment of the right to dividends.[51] This position ignores

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46. *Id.*

> Whether [the petitioner elected to waive her rights to the accumulated dividends] because she intended to equalize the ownership of the stock of the corporation through gifts of three-fourths of the preferred stock to her children during the next year, as actually eventuated, or whether she desired to make three-fourths of the earnings of the corporation available to her children as the owners of the common stock, it is clear that her waiver benefited them.

*Id.*

47. *Id.*

48. *See, e.g.,* L. LOWNDES, R. KRAMER, & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES § 26.7 (3d ed. 1974) [hereinafter cited as LOWNDES].

49. *Id.*

50. 1 T.C. 911 (1943).

51. *See* LOWNDES, *supra* note 48, § 26.7.

the distinction that an assignment is made in favor of a specifically designated person or group of persons while a waiver of dividend rights is a general relinquishment of those rights to the corporation, not to any specifically designated shareholder or group of shareholders. A shareholder's waiver of his right to receive dividend income for a particular period of time benefits all nonwaiving shareholders proportionately, whether by increased dividends or by an increase in the value of their stock, and cannot be said to bestow any benefits upon those shareholders who are relatives of the waiving shareholder to the exclusion of unrelated shareholders. Thus a waiver of dividends in which some but not all nonwaiving shareholders are related to the waiving shareholder should not be treated as an assignment by a shareholder only to his relatives. Under assignment of income principles the relationships between the waiving and nonwaiving shareholders should be irrelevant in determining whether a gift was made.

A conflict exists between the rationales of the *Collins* majority on one side and the *Collins* dissent and *Bagley* on the other concerning whether a dividend waiver constitutes a gift. In both cases, all nonwaiving shareholders were related to the waiving shareholder.[52] The *Collins* court stressed the business purposes for the waiver and relied on the theory that no gift could have been made because no "property" had been transferred. The *Bagley* court placed little emphasis on the alleged business purpose for the waiver; rather, it focused on the family relationship present in the transaction. The differing foci of these two courts illustrate the pervasive conflict between the recognition of bona fide business purposes and the suspicion toward transactions involving familial ties as being sham transactions executed primarily for tax avoidance purposes.

The *Collins* majority opinion did not indicate whether, if the waiver of the right to dividends was found to be a gift to the corporation, it actually would constitute a gift to minority shareholders. The dissent's answer to this issue—that the waiver did constitute a gift to the other shareholders—gained support in Treasury Regulation section 25.2511-1(h)(1), which states that a transfer of property to a corporation for less than adequate and full consideration represents a gift by the donor to the individual shareholders of the corporation to the extent of their proportionate interests in the corporation.[53]

52. *See* text accompanying notes 13 & 39 *supra*.

53. Treas. Reg. § 25.2511-1(h)(1) (1958). The regulation excepts transfers to charitable, public, or political organizations.

That a gift to a corporation constitutes a gift to its shareholders raises another gift tax question—whether a donor of a gift to a corporation may claim a single exclusion for the donee corporation or an exclusion for each shareholder donee.[54] The Service's policy of refusing to allow any annual exclusion whatsoever in the case of a gift to a corporation is exemplified in *Heringer v. Commissioner.*[55] In *Heringer* forty percent of a corporation was owned by two couples and the remaining sixty percent was owned by their children. After the two couples transferred farmland to the corporation for no consideration, the United States Court of Appeals for the Ninth Circuit held that the transfer was a taxable gift. The court rejected taxpayers' contentions[56] that because the land transfers were transactions in the ordinary course of business and were made without donative intent, they should be considered as having been made for adequate and full consideration in money or money's worth. The court countered this contention with the statement that the familial relationships present in the transactions created a presumption of gift.[57] The court agreed, however, with taxpayers' argument that the transfer proportionately increased the value of all the stock of the corporation, including their forty percent. Thus the court held that the two couples parted with sixty percent of the value of the increased net worth of the corporation and therefore had made a gift of that amount.[58]

Taxpayers' final claim was that if the transfer constituted a gift, the donees were other shareholders rather than the corporation, and therefore the taxpayers were each entitled to a three thousand dollar annual exclusion for each shareholder donee.[59] The court responded that it need not decide whether the donee was the corporation or the other shareholders because, if the children were deemed to be the donees, the interests taken by them were "future interests" and therefore not excludable under the annual exclusion provisions

54. I.R.C. § 2503(b) allows a taxpayer to exclude from gift tax liability gifts of up to $3000 per year per donee. Gifts of future interests in property, however, are explicitly not entitled to this exclusion.

55. 235 F.2d 149 (9th Cir. 1956).

56. *Id.* at 151.

57. *Id.*

58. *See id.* at 153.

59. *Id.* at 151. Taxpayers relied on Helvering v. Hutchings, 312 U.S. 393 (1941), in which the Supreme Court held that the taxpayer, having made a gift to a trust, was entitled to an exclusion for each beneficiary of the trust. The Court rejected the argument that the trust itself, rather than its beneficiaries, was the donee for purposes of the annual exclusion. The *Heringer* court recognized, however, that other cases have held that the corporate entity controls in determining who is the donee. 235 F.2d at 151.

of the Code.[60] Stating that the proper test was whether the donee is given present power of possession and enjoyment of the gift, the court reasoned that the shareholders of the corporation could possess or enjoy the land or related income only upon a declaration of dividends at some point in the future. The court thus held that under no circumstances would the taxpayers be allowed an annual exclusion for each shareholder of the corporation.[61]

## IV. Possible Guidance Through Analogy

As the discussion above indicates, substantial confusion exists concerning the proper income tax and gift tax treatment of a dividend waiver. Neither the courts nor the Service have adequately defined the standards that should be used to determine the issue. One of the principal problems in the area is the difficulty in determining the proper definitions of "relatives" and "substantial benefit to relatives." For aid in interpreting these terms a taxpayer might look to Revenue Procedure 67-14.[62] This procedure provides that the Service will consider a request for an advance ruling only if relatives of the waiving shareholder will not receive more than twenty percent of the total dividends distributed to nonwaiving shareholders. Whether the Service intended this twenty percent limit to be binding on itself and on taxpayers in all actual dividend

60. *Id.* at 151-52. *See* note 59 *supra*. The dissenting opinion in *Collins*, however, argued that shareholder taxpayer should be allowed three annual exclusions for a gift to the corporation of which her three children were the only other shareholders. 1 T.C. at 610.

61. The court's conclusion in *Heringer* was followed by Revenue Ruling 71-443, 1971-2 C.B. 338, in which the Service held that a gift to a corporation was a gift of a future interest to its shareholders and thus did not qualify for the annual exclusion.

62. 1967-1 C.B. 591. Revenue Procedure 67-14 specifies the conditions that must be present before the Service will consider a request for a ruling on a proposed waiver of dividends transaction. Those conditions are as follows:

> .01 A bonafide business reason must exist for the proposed waiver of dividends.
>
> .02 The relatives of the stockholder proposing to waive his right to future dividends must not be in a position to receive more than 20 percent of the total dividends distributed to the nonwaiving shareholders. For this purpose the relatives of a waiving stockholder include his brother and sister (whether by the whole or half blood), spouse, ancestors, and lineal descendants, the spouses of his brothers and sisters (whether by the whole or half blood) and the spouses of his lineal descendants.
>
> .03 A ruling issued on a proposed waiver of dividends transaction will clearly indicate that the ruling will no longer be applicable if any change in the stock ownership during the waiver period enables nonwaiving relatives to receive more than 20 percent of a dividend, unless the change occurs because of death.
>
> .04 A ruling issued on a proposed waiver of dividends transaction will not be effective for a period longer than three years from the date of the ruling.
>
> .05 A request for a ruling on a proposed waiver of dividends transaction must be submitted to the National Office in accordance with Revenue Procedure 67-1, page 544, this Bulletin.

waiver situations or whether the limit is merely a prerequisite for consideration of a proposed ruling remains uncertain. If no advance ruling is obtained before a dividend waiver is executed, it is not clear whether the Service will strictly adhere to the twenty percent limit and thus refuse to attack a dividend waiver in which related shareholders received less than twenty percent of the waived dividends. In this situation the Service might well argue that the twenty percent figure is not an absolute boundary but only a suggested guideline. Similar questions arise in the context of a taxpayer attempting to defend a dividend waiver that resulted, for example, in his relatives receiving twenty-one percent of the total dividends paid during the period in which the waiver was in effect.

The problem becomes even more complex when nonwaiving shareholders do not receive any increased dividend by virtue of the waiver, but instead, the amount of money that would have been paid to the waiving shareholder remains in the corporation. In this case it is unclear whether the twenty percent figure would apply only to those dividends actually paid or would also apply to the amount of the increase in value of the stock of the corporation resulting from the increase in retained earnings. If the twenty percent limit applies absolutely in all dividend waiver situations, further problems arise concerning valuation of increases in the value of stock and in the technical application of the twenty percent rule.[63] Contrarily, if the twenty percent rule does not apply as an absolute limit, then the question of the proper standard to determine what constitutes "substantial benefit" remains open to both the Service and taxpayers. Regardless of whether the twenty percent standard is justifiable, reasonable, or even workable, it does provide some guidance in an area in which uncertainty has created substantial burdens for the Service and taxpayers.

In determining the scope of the phrase "relatives of the waiving shareholder," Revenue Procedure 67-14 may be of assistance. This procedure expressly identifies certain degrees of kinship that will be considered "relatives" for purposes of an advance ruling.[64] As with

63. In regard to valuation when dividends actually are paid to the nonwaiving shareholders, the Commissioner's position in *Collins* was that taxpayer's waiver constituted a gift in the amount of the total accumulated dividend arrearages on her preferred stock, less one annual exclusion. 1 T.C. at 607. This seems excessive because the waiver did not cover declared dividends, but instead covered the *right* to future dividends *if* any were declared at a later date. With no guarantee that any dividends would ever be declared, such a naked legal right should have a low value unless the nonwaiving shareholders are in a position of such control over the corporation as to direct the declaration of dividends. When no dividends are paid and the waiver serves only to increase the value of the stock, valuation problems are even more difficult.

64. Revenue Procedure 67-14 provides in pertinent part: "For this purpose the relatives

the twenty percent standard, however, whether this provision will be binding in diagnosing the taxability of every dividend waiver is uncertain. Further, even if these illustrations are binding and such persons will definitely be considered relatives of the waiving shareholder, the language employed by the Service does not indicate whether the enumerated categories are to be considered exclusive.[65] The categories expressly mentioned do not include such collateral relatives as aunts and uncles or nieces and nephews and also make no reference to entities such as trusts or corporations. Thus the taxpayer has no guidance concerning whether these persons and entities will be considered "relatives of a waiving shareholder." The taxpayer remains similarly perplexed as to whether constructive ownership or attribution rules of other sections of the Code apply to a dividend waiver.[66] These additional uncertainties aggravate the burden already placed on the taxpayer by the lack of standards for determining what constitutes "bona fide business purposes," "substantial benefits," and "relatives" in a dividend waiver situation.

As a consequence of the failure of the cases and revenue rulings expressly addressing dividend waivers to delineate clearly the income and gift tax consequences of such transactions, taxpayers must look to analogous areas of tax law to structure an argument that dividend waivers should not be subjected to income or gift tax liability. One area in which analogies might be helpful is in determining what constitutes a bona fide business purpose for a waiver of dividends. When a shareholder waives his right to dividends and the amount that would have been paid to him is not paid out to other shareholders, the waiver has the effect of increasing the retained earnings. This can be analogized closely to a situation in which a corporation accumulates earnings by declaring only nominal dividends or no dividends at all. Thus, to determine what business purposes will be deemed legitimate for dividend waivers, the taxpayer could examine Treasury Regulations identifying the business needs that may be considered sufficient to justify accumulations of corporate earnings and to preclude imposition of the accumulated earnings penalty tax.[67] These business needs include the accumulation of reasonable reserves for immediate and anticipated

of a waiving stockholder include his brother and sister (whether by the whole or half blood), spouse, ancestors, and lineal descendants, the spouses of his brothers and sisters (whether by the whole or half blood) and the spouses of his lineal descendants." 1967-1 C.B. 591, 592.

65. *See* note 64 *supra*.

66. *See* I.R.C. §§ 318, 544.

67. *See* I.R.C. §§ 531-537 (providing for a tax on accumulations of earnings and profits by corporations beyond the reasonable needs of the business).

business needs, risks and contingencies such as bona fide expansion of the business, replacement of the physical plant, retirement of bona fide business indebtedness, working capital for inventories and operations, acquisition of a business through the purchase of stock or assets, and investments or loans to suppliers and customers necessary to maintain the business.[68]

Another area analogous to dividend waivers is the tax treatment of interest-free loans. In the case of an interest-free loan, the lender gives up his right to receive interest income by not charging interest on the loan. Similarly, a shareholder gives up his right to receive dividend income when he waives his rights to receive future, undeclared dividends. In a 1977 private letter ruling, the Service, following established case law, held that no gross income will be imputed to the lender of an interest-free loan.[69] Thus, just as a lender has no absolute right to interest and will not be taxed as having received interest income when he chooses not to charge interest on a loan, a shareholder has no matured, fixed right to receive dividends until they are declared and therefore should not be taxed as having constructively received a dividend because of a waiver of the undeclared dividends.

The interest-free loan analogy may also be relevant to determine the gift tax consequences of a dividend waiver. The Service has argued that interest-free loans constitute a taxable gift from the lender to the borrower. Revenue Ruling 73-61 held that interest-free loans between related persons, whether made for a fixed period of time or payable on demand, are taxable gifts from the lender to the borrower to the extent of the value of the use of the money at the time of the transfer.[70] In *Crown v. Commissioner,*[71] however, the Tax Court stated that Revenue Ruling 73-61 was not persuasive and held that the lender of an interest-free loan incurs no gift tax liability. The court intimated that the extension of gift tax liability to the interest-free loan situation was a matter for Congress rather than

68. *See* Treas. Reg. § 1.537-2 (1954). *See also* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 8.03-.04 (1971).

69. I.R.S. Letter Ruling 7731007 (April 29, 1977).

70. 1973-1 C.B. 408. Revenue Ruling 73-61 sets forth the Commissioner's position:

> The right to use property, in this case money, is itself an interest in property, the transfer of which is a gift within the purview of section 2501 of the Code unless full and adequate consideration in money or money's worth is received. The tax . . . would be imposed on the value of the right to use the money.

*Id.* at 409. The ruling also specifically refuses to follow Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966) (holding that an obligation to pay interest can only arise from express or implied contractual obligations or from statute).

71. 67 T.C. 1060 (1977).

the courts.[72] The United States Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision in *Crown,* noting that the tax laws make no provision for the taxation of potential interest.[73] This reasoning can also be applied to support the argument that a waiver of undeclared, future dividends should not be treated as a taxable gift. Indeed, the argument for finding a gift seems stronger in the case of interest-free loans than in the case of dividend waivers because the lender chooses to give up his right to interest in favor of a particular borrower, while the waiving shareholder gives up his right to dividend income in favor of the corporation, and thus to all shareholders in general. Because interest-free loans have been held not to constitute gifts and the *Collins* court held a dividend waiver not to be a gift, a persuasive argument can be made that a waiver of dividends is not taxable as a gift. If, however, a shareholder attempted to limit his waiver in a way that would benefit only a particular shareholder or group of shareholders, the waiver would be an assignment to those particular shareholders of his right to receive dividend income rather than a general waiver and should be taxable to him under assignment-of-income and gift tax principles.

Another comparison can be made between a waiver of a corporate shareholder of his right to dividends and waivers by executors and fiduciaries of their right to statutory fees and commissions. Waiver of a right to dividends results in economic benefit to the corporation and thus benefit to the other shareholders. Similarly, waiver of a right to fees and commissions results in economic benefit to the estate or trust and thus benefit to the beneficiaries of the estate or trust. The Service has held that a waiver of statutory fees and commissions by an executor or fiduciary is neither constructive income nor a taxable gift. In Revenue Ruling 66-167[74] the Service held that statutory fees or commissions are not includible in the gross income of,[75] nor will be considered as a gift made by, the executor of an estate who effectively and timely waived his right to receive such fees or commissions and whose other actions regarding the estate were consistent with an intention to render his services gratuitously. The Service also stated that the waiver would not be considered a gift. The Service pointed out that a waiver of commissions by a fiduciary might have income and gift tax consequences

72. The court relied on the federal district court decision in Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966), as the only prior case that had considered the precise issue in question. *See* note 70 *supra.*

73. 78-2 U.S. Tax Cases ¶ 13,260 (7th Cir. Sept. 19, 1978).

74. 1966-1 C.B. 20.

75. *See also* Rev. Rul. 70-237, 1970-1 C.B. 13.

for the fiduciary if, through his waiver, he in effect transfers his income interest to a third party. The Service attempted to clarify its opinion, however, by emphasizing the importance of the timing, purpose, and effect of the waiver. Attaching particular importance to the timing of the waiver, the Service noted that the executor had waived his rights within a reasonable time after commencing to serve as executor. The Service distinguished this from a case in which a trustee waives his rights to commissions after he has performed substantial services.[76] In the latter case, the trustee would be subject to income and gift tax liability on the commission that had accrued to him for services rendered before the waiver.

The focus of the Service's analysis in Revenue Ruling 66-167 was upon whether the waiver was made primarily for the purpose of rendering gratuitous services rather than upon whether the rights to commissions had "matured" or "accrued" sufficiently to be susceptible of constructive receipt. The latter question, however, was the focus of the Tax Court's analysis of a similar waiver in *Breidert v. Commissioner.*[77] In *Breidert* the Tax Court held that, for income tax purposes, an executor could not be considered to have constructively received commissions that he had formally waived, notwithstanding the facts that estimated executor's fees had been deducted on an estate tax return and that a court order had erroneously provided for payment of executor's fees. The Commissioner argued that the executor-taxpayer constructively received executor's fees in the amount to which he was entitled by statute either because he did not effectively waive his right to such commissions or because his waiver was made after his right to the commissions had matured to the point that he could not avoid realization of the income by refusing receipt. In holding that the taxpayer was not in constructive receipt of the commission, the Tax Court reasoned that although the executor had an absolute right by statute to commissions for his services, this right did not accrue under state law until an order for payment was made by the probate court. Thus the court held that the executor was entitled to waive his right to commissions at any time before the court ordered payment.

Application of the *Breidert* rationale to the dividend waiver situation suggests that a shareholder's right to a dividend has not accrued until the corporation has declared a dividend and ordered payment. Thus a shareholder should be able to waive his right to dividend payments at any time prior to the declaration of a divi-

76. *See* Rev. Rul. 64-225, 1964-2 C.B. 15.
77. 50 T.C. 844 (1968), *acq.*, 1969-2 C.B. xxiv.

dend by the corporation without subjecting himself to income tax liability through the doctrine of constructive receipt. The Tax Court's position in *Breidert*—that no factual basis existed for an application of the doctrine of constructive receipt because the commissions were never credited to the taxpayer's account, set apart for him, or otherwise made available to him—should apply with equal force to a dividend waiver. Clearly, a dividend cannot have been credited to, set aside for, or made available to a shareholder when it has not yet been declared.

An additional analogy can be made between a dividend waiver and the situation in which an employee has an option to take a retirement annuity solely for himself or to take a smaller annuity for himself with a survivorship annuity payable to his wife. In this situation, the employee gives up his right to future payment of a portion of the total annuity to which he is entitled. Similarly, in the dividend waiver situation, the waiving shareholder parts with his right to future payment of the total amount of dividends to which he would become entitled upon the declaration of a dividend by the corporation. The Service has indicated that an irrevocable election by an employee to take the joint annuity with right of survivorship does result in a taxable gift.[78]

Although the analogies discussed are not binding on either the Service or the courts, they are helpful in pointing out various lines of analysis that a taxpayer should consider when contemplating a possible waiver of dividends. Because the proper tax treatment of a dividend waiver is unclear, taxpayers must be aware that the Service may challenge any waiver in which the nonwaiving shareholders have some familial tie with the waiving shareholder. The analogies presented in the discussion simply provide the taxpayer with a basis for arguments in defense of a waiver.

## V. Conclusion

In attempting simultaneously to prevent tax abuse and to uphold bona fide business transactions, the Service and the courts have created substantial confusion concerning the proper tax treatment of dividend waivers. With regard to income tax, the Service's attempts to utilize a number of conceptually inadequate doctrines to impose tax liability on waiving shareholders has merely compounded the confusion. The uncertain possibility of gift tax liability poses an additional problem for the taxpayer. Thus taxpayers considering the use of a dividend waiver to assist the accumulation of

78. *See* Treas. Reg. § 25.2511-1(h)(10) (1958).

corporate funds may be forced to rely on analogous areas of tax law to clarify otherwise uncertain tax consequences. Use of analogy, for example, may aid the taxpayer in determining which business purposes may be considered sufficient to justify a dividend waiver and in defining technical terms frequently employed by courts in imposing tax liability. Moreover, a number of analogies persuasively suggest that the imposition of income and gift tax liability on a waiving shareholder may be inappropriate. Although not binding precedent, these analogies may substantially assist taxpayers by identifying probable tax treatment and by providing arguments with which dividend waivers may be defended against challenges by the Service.

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