



March 8, 2006
Pennsylvania Personal Income Tax
No. PIT-06-003
Disposition of Property/Net Gains; Dividend

ISSUE

Is the final distribution that each Taxpayer received in tax year 2000 from Company A, which was dissolved in tax year 2002, a taxable dividend or a net gain from the disposition of property for Pennsylvania Personal Income Tax purposes?

CONCLUSION

The distribution each Taxpayer received in tax year 2000 was a taxable dividend because the distribution was paid out of the earnings and profits of the corporation.

FACTS

In 1996, Company A was formed, and Taxpayers each owned a fifty percent interest. Company A was formed for the purpose of holding an investment in Company B, which in turn held an interest in Company C. In 1999, Taxpayers moved from a foreign country to Pennsylvania, and in 2000 Company A ceased active operations because the underlying investments held by Company B were sold. Company A did not adopt a formal plan of liquidation, but it undertook a number of steps consistent with liquidating and dissolving the corporation, i.e. it sought legal advice on the various methods of dissolving a foreign company and advised its lawyer of its intention to liquidate. The corporate resolution authorizing Company A's dissolution was passed in 2002.

Taxpayers received a cash payment in tax year 2000. This payment was the only distribution they received on the liquidation and dissolution of Company A. The corporation obtained certain clearance certificates, and the final dissolution was complete in 2002.

At the time of the distribution, the paid-up capital of Company A was equal to US \$1.00. For foreign tax purposes, the amount received was deemed to be a dividend by the foreign country, for the 2000 tax year. Taxpayers were also required to report the distribution on their Federal 1040 as a dividend because the distribution was made from the earnings and profits of a foreign corporation which the Taxpayers controlled.

DISCUSSION

The Tax Reform Code of 1971 (the TRC), as amended, provides for the imposition of a personal income tax on eight classes of income. The two income classes which are pertinent to a shareholder's receipt of cash from a corporation are 'net gains or income from disposition of property' and 'dividends.' 72 P.S. § 7303(a) (3) and (a) (5). The TRC describes 'net gains or income from disposition of property' as follows:

Net gains or net income, less net losses, derived from the sale, exchange or other disposition of property, including ... intangible personal property ... as determined in accordance with accepted accounting principles and practices.

72 P.S. § 7303(a) (3).

The TRC defines dividends as –

[A]ny distribution in cash or property made by a corporation, association, business trust or investment company with respect to its stock out of accumulated earnings and profits or out of earnings and profits of the year in which the dividend is paid: Provided, however, That the term “dividends” shall not include:

(i) a distribution of the stock of a corporation made by the corporation originally issuing same to its own stockholders if such distribution is not treated as personal income for Federal individual income tax purposes.

72 P.S. § 7301(f).

Regulation section 103.13 states that a “return of capital” distribution is a distribution which is not made or credited by the business corporation or association from its earnings or profits. 61 Pa. Code § 103.13.

In contrast to these sections, the Internal Revenue Code (IRC) Section 301 provides that the general rule for the taxation of a property distribution that is made with respect to a corporation’s stock shall be treated as a dividend when the distribution is made from the corporation’s earnings and profits, but it includes an exception to this general rule which provides generally that distributions made in a corporate liquidation are not considered dividends, but are treated as a gain or loss on the sale or exchange of the shareholder’s stock as provided in IRC § 331. IRC § 1248, however, requires a taxpayer to include any gain recognized on the sale or exchange of shares of certain foreign corporations as dividend income to the extent of the corporation’s earnings and profits that are attributable to the shares exchanged or sold. The TRC does not contain provisions similar to the exceptions contained in IRC § 301 or IRC § 331.

Thus, the definitions contained in the TRC permit a distribution received by a shareholder from a corporation that has earnings and profits and is being liquidated, to be viewed two ways: as income from the disposition of property and also as a dividend to the extent of the earnings and profits that are attributable to the shares liquidated. The Statutory Construction Act (the SCA) provides that statutes or parts of statutes that relate to the same persons or things or to the same class of persons or things are to be construed together and effect should be given to both provisions unless the sections are irreconcilable. 1 Pa.C.S. §§ 1932 – 1934; See also: *Commonwealth, Department of Transportation v. Campbell*, 588 A.2d 75, 138 Pa. Cmwlth. 337 (1991); *McKinney v. Board of Commissioners of Allegheny County*, 410 A.2d 1238, 488 Pa. 86 (1980); *Duquesne Light Co. v. Borough of Monroeville*, 298 A.2d 252, 449 Pa. 573 (1972).

Therefore, since the term ‘dividends’ is defined as “[a]ny distribution in cash or property ... out of earnings and profits,” a liquidating distribution is taxable as dividends to the extent of

the corporation's earnings and profits attributable to the taxpayer's shares. 72 P.S. § 7301(f). Any portion of the distribution which exceeds the amount of the earnings and profits attributable to the liquidated shares would be income from the sale, exchange, or other disposition of property. This treatment of the liquidating distribution gives effect to both income classes. Additionally, even though the use of the term 'return of capital' in Regulation Section 103.13 relates to shares exchanged in a reorganization, acquisition or recapitalization rather than a liquidation, this Regulation's reference to 'return of capital' also supports the treatment of Taxpayers' distribution as a dividend since the Regulation states that a 'return of capital' does not include a distribution made out of earnings and profits.

Since Company A's distribution was taxable as a dividend under IRC § 1248 because it was made out of earnings and profits, Taxpayers' distribution is also a dividend for Pennsylvania Personal Income Tax purposes. Thus, even if the Department accepts Company A's assertion that the distribution made in tax year 2000 was a liquidating distribution despite the fact that Company A did not pass a corporate resolution authorizing the dissolution of the corporation until 2002, the distribution still qualifies as a dividend since it was made out of the business' earnings and profits attributable to Taxpayers' shares.