

dividend (in addition to the general meaning set forth in section 316(a)) also means a nonliquidating distribution to its shareholders to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to such distributions) for the taxable year in which or in respect of which the distribution is made. See paragraph (b)(1) of § 1.316-1.

[T.D. 6949, 33 FR 5529, Apr. 9, 1968, as amended by T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.562-2 Preferential dividends.

(a) Section 562(c) imposes a limitation upon the general rule that a corporation is entitled to a deduction for dividends paid with respect to all dividends which it actually pays during the taxable year. Before a corporation may be entitled to any such deduction with respect to a distribution regardless of the medium in which the distribution is made, every shareholder of the class of stock with respect to which the distribution is made must be treated the same as every other shareholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class. The limitation imposed by section 562(c) is unqualified, except in the case of an actual distribution made in connection with a consent distribution (see section 565), if the entire distribution composed of such actual distribution and consent distribution is not preferential. The existence of a preference is sufficient to prohibit the deduction regardless of the fact (1) that such preference is authorized by all the shareholders of the corporation or (2) that the part of the distribution received by the shareholder benefited by the preference is taxable to him as a dividend. A corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there

is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated. The disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. As used in this section, the term *distribution* includes a dividend as defined in subchapter C, chapter 1 of the Code, and a distribution in liquidation referred to in section 562(b).

(b) The application of the provisions of section 562(c) may be illustrated by the following examples:

Example 1. A, B, C, and D are the owners of all the shares of class A common stock in the M Corporation, which makes its income tax returns on a calendar year basis. With the consent of all the shareholders, the M Corporation on July 15, 1954, declared a dividend of \$5 a share payable in cash on August 1, 1954, to A. On September 15, 1954, it declared a dividend of \$5 a share payable in cash on October 1, 1954, to B, C, and D. No allowance for dividends paid for the taxable year 1954 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1954, and October 1, 1954.

Example 2. The N Corporation, which makes its income tax returns on the calendar year basis, has a capital of \$100,000 (consisting of 1,000 shares of common stock of a par value of \$100) and earnings or profits accumulated after February 28, 1913, in the amount of \$50,000. In the year 1954, the N Corporation distributes \$7,500 in cancellation of 50 shares of the stock owned by three of the four shareholders of the corporation. No deduction for dividends paid is permissible under section 562(c) and paragraph (a) of this section with respect to such distribution.

Example 3. The P Corporation has two classes of stock outstanding, 10 shares of cumulative preferred, owned by E, entitled to \$5 per share and on which no dividends have been paid for two years, and 10 shares of common, owned by F. On December 31, 1954, the corporation distributes a dividend of \$125, \$50 to E, and \$75 to F. The corporation is entitled to no deduction for any part of such dividend paid, since there has been a preference to F. If, however, the corporation had distributed \$100 to E and \$25 to F, it would have been entitled to include \$125 as a dividend paid deduction.