KINDER MORGAN INC.

Qualified Dividends vs. Return of Capital Distributions

Earnings & Profits

Based on guidance from the Internal Revenue Service, Earnings & Profits (E&P) is the measure of a corporation's ability to make distributions to its shareholders without distributing any capital previously contributed by either shareholders or creditors. Compared to GAAP net income, KMI's E&P in recent years has been considerably lower primarily due to much higher E&P depreciation expense relative to GAAP depreciation expense.

Internal Revenue Code Section 316(a) and 301(c): **Distributions Treated as a Return of Capital**

The Internal Revenue Code provides that a cash distribution (e.g. a dividend) made by a corporation to its shareholders out of its current year E&P and accumulated E&P, if any, is a qualified dividend and shall be included in gross income. Any portion of a cash distribution in excess of the current and accumulated E&P is treated as a distribution of property, which reduces the basis of the stock. This portion of distributions is commonly referred to as a return of capital. Return of capital distributions are not included in gross income unless they exceed the stock basis; in that case, the excess shall be treated as a capital gain.

Form 8937: Report of Organizational Actions Affecting Basis of Securities.

The Department of Treasury requires a corporation to file Form 8937 if it pays a distribution that is treated as a return of capital because it affects the basis of all holders of its stock. Form 8937 is required to be posted on the corporation's primary public website on or before the 45th day following the distribution payment or, if earlier, January 15 of the year following the calendar year.

What is the Tax Treatment of a <u>Qualified Dividend</u>?

Cash distributions from C-corporations are typically qualified dividends and generate taxable dividend income. For U.S. individuals, such dividend income will be subject to tax at short-term or long-term capital gains rates depending on their holding period.

What is the Tax Treatment of <u>Return of Capital</u>?

A return of capital distribution does not trigger any tax if the holder's basis in the stock is equal to at least the amount of the return of capital distribution. Instead, the distribution merely reduces the shareholder's basis in his or her shares of stock. If the amount of the return of capital distribution is in excess of the shareholder's cost or other tax basis, such excess is taxable as capital gain. <u>See</u> the Instructions to Recipients – Box 3 on the 2018 Form 1099-DIV or IRS Publication 550, Investment Income and Expenses. The non-dividend distribution language on Box 3 should be read with care in conjunction with the Instructions to Recipients explanation to Box 3 contained in the notes to Form 1099-DIV.

EXAMPLE

In **Year 1**, 1,000 shares were purchased on January 3 for $20 per share; therefore, tax basis is $20,000. The shareholder receives dividend payments of $125 in February, May, August, and November for a total of $500. Current and accumulated E&P are sufficient to cover all of Year 1 distributions. The $500 of distributions received in Year 1 are taxable dividends and are included in shareholder's taxable income. The dividends are qualified because they are paid by a U.S corporation and the shareholder has met the holding period requirement.

Year 1 Distributions

Distribution	Date
$125.00	Feb
$125.00	May
$125.00	Aug
$125.00	Nov
$500.00	

In **Year 2**, the shareholder continues to own the same 1,000 shares and receives a distribution of $125 in February, and distributions of $200 in May, August, and November for a total of $725. Current and accumulated E&P are not sufficient to cover all of Year 2 distributions. The current and accumulated E&P is sufficient to cover 100% of the February distribution and 42% of the May distribution, therefore the remaining distributions are return of capital.

Year 2 Distributions

Distribution	Date	Taxable Dividend %	Taxable Dividend Amount	Return of Capital %	Return of Capital Amount
$125.00	Feb	100%	$125.00	0%	$0.00
$200.00	May	42%	$84.00	58%	$116.00
$200.00	Aug	0%	$0.00	100%	$200.00
$200.00	Nov	0%	$0.00	100%	$200.00
$725.00			$209.00		$516.00

Return of Capital Basis Adjustment

$20,000.00	Purchase price on January 3
($516.00)	Year 2 Return of Capital
$19,484.00	Tax basis after Year 2 distributions

Basis cannot go below zero. Once basis gets to zero, return of capital will no longer reduce basis and must be reported as capital gain.

Information about the Tax Treatment of Distributions.

Please note: The information contained herein provides a general overview of distributions related to the ownership of stock for US tax purposes. It does not discuss all aspects of individual shareholder circumstances and does not constitute formal tax advice. Shareholders are encouraged to consult their own tax advisors regarding their individual circumstances.