Analysis of earnings and profits with recommendations

American Institute of Certified Public Accountants. Earnings and Profits Task Force

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An Analysis of Earnings and Profits With Recommendations

Taxation of Corporate Distributions and Adjustments Subcommittee

Earnings and Profits Task Force

AUGUST 1978
An Analysis of Earnings and Profits With Recommendations

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Preface

**Part I - Problems Studied and Recommendations**

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Earnings and profits, certainly one of the most important areas in both corporate and individual tax law, is unfortunately one of the most confusing. Nowhere is the term "earnings and profits" defined in the Internal Revenue Code; the definitions that exist have come from a welter of conflicting and contradictory cases and rulings.

In 1974, the Tax Division of the American Institute of Certified Public Accountants began an exhaustive study of the area of earnings and profits. Although numerous recommendations had been made previously by various scholars and practitioners, none had been comprehensive in scope. Therefore, a task force composed of Earl C. Brown, Jerome Toder, and Paul Farber was formed to analyze various problem areas.

To meet the ultimate objective, the task force members proposed a three-stage plan of study. The first stage of the plan was to gather all available information in the area so that task force members could be thoroughly familiar with all source documents. Therefore, a compendium of relevant Code and regulations sections, legislative history, revenue rulings, revenue procedures, court decisions, articles, and scholarly presentations of various types was prepared.

The second stage of the plan was to summarize all available information in the area. To this end, reports were prepared summarizing the contents of all relevant law review articles and scholarly presentations. Summaries of key court decisions, revenue rulings, and revenue procedures, as well as summaries of the relevant legislative history, Code and regulations sections were drafted.
The third stage of the plan was for task force members to identify problem areas after they had studied the prepared source material. The task force then examined these areas and made recommendations for the solution of those problems.

This report on earnings and profits consists of three parts. Part I contains Problems Studied and Recommendations. Each topic covered begins with a brief statement of the problem, followed by a discussion of its current status under the law. Further analysis of the problem is provided in the "Commentary" section, which often summarizes the viewpoints of published expert opinion on the subject. These materials provide the basis for the statement of the task force's recommendation, which appears at the conclusion of the discussion.

Part II of this report contains the task force's overall proposal to simplify the computation of earnings and profits.

Appendixes of Source Materials on Earnings and Profits are provided in Part III. They contain the citations to the cases, Treasury rulings, and legislation relevant to earnings and profits, including those mentioned in the text. Finally, Part III features an annotated bibliography of works in the area of earnings and profits.
PART I.

PROBLEMS STUDIED AND RECOMMENDATIONS
CHAPTER 1: EARNINGS AND PROFITS IN REORGANIZATIONS

Insufficient Earnings and Profits to Cover Property Distributions

The general rules regarding adjustments to be made to earnings and profits for distributions in kind have been codified in sec. 312. However, sec. 312 leaves unanswered the question of how earnings and profits are to be allocated among shareholders when determining the dividend status of such a distribution if the total earnings and profits of the corporation are not sufficient to cover the entire distribution.

Current Status of the Law

Code and Regulations

This question has been answered by sec. 356 and reg. sec. 1.356-1 for distributions in kind received in a reorganization exchange. Sec. 356(a)(2) provides that

... there shall be treated as a dividend to each distributee such an amount of the gain recognized ... as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized ... shall be treated as gain from the exchange of property.

Sec. 356(a), however, does not apply to distributions in kind made in connection with a transaction to which sec. 355 applies, since no exchange is involved in the transaction. Rather, according
to sec. 356(b), these distributions are to be treated under the general distribution provision, sec. 301. It is under this general provision that the question remains as to how earnings and profits are to be allocated among recipient shareholders in determining the dividend status of such distributions.

Recommendations

The rules with regard to earnings and profits and distributions in kind in corporate reorganizations have been codified in secs. 312 and 356 and have been expanded upon in the regulations thereunder; the remaining question is one governed by the general provisions concerning distributions in kind, and this question is being considered separately in this study. Therefore, no recommendations are being made for revisions or additions to the existing regulations.

Earnings and Profits Disappearance and Reappearance as Capital

The issues raised under this subject pertain to the carryover of the earnings and profits of the acquired corporation in a reorganization. Basically, the issues are whether the earnings and profits of the acquired corporation continue to exist subsequent to the reorganization, and, if so, whether they may be combined with the earnings and profits of the acquiring corporation.
Current Status of the Law

Code

Sec. 381(c)(2) states that the earnings and profits or deficit in earnings and profits of the acquired corporation will be treated as received or incurred by the acquiring corporation as of the date of the distribution or transfer and that any deficit in the earnings and profits of either the acquired or the acquiring corporation may only be used to offset earnings and profits accumulated after the date of distribution or transfer.

Leading Cases

These issues have been resolved in the cases of Sansome (1932), Phipps (1949), and Snider (1955), and the holdings regarding the carryover of earnings and profits in all three of these cases have been codified in sec. 381(c)(2).

Recommendations

Since the issues of carrying over earnings and profits of acquired corporations have already been adequately covered by sec. 381(c)(2) and the regulations thereunder, no recommendations are being made for revisions or additions to the existing regulations.
This problem concerns the possible bail-out of earnings and profits at capital gains rates through the use of a recapitalization consisting of the exchange of stock of a corporation for bonds or other securities.

If a shareholder receives a dividend of securities of a corporation, he must recognize as ordinary income the fair market value of this dividend, assuming sufficient earnings and profits. If, however, he receives these securities in a "recapitalization," under secs. 354(a)(2)(B) and 356(d), he must recognize ordinary income from their receipt only to the extent of his gain on the exchange; he may then later bail out earnings and profits at capital gain rates by selling the securities or causing the corporation to retire them.

Current Status of the Law

Code and Regulations

Although there are no provisions in the Code which specifically deal with the prevention of the above-stated problem, reg. secs. 1.331-1 and 1.301-1 do apply to such possible bailing out of earnings and profits at capital gain rates.

Reg. sec. 1.331-1(c) provides that a liquidation that is either followed or preceded by a transfer to another corporation of all or part of the assets of the liquidating corporation may have the effect of a dividend distribution or of a transaction in which
no loss is recognized and gain is only recognized to the extent of "other property" received.

Reg. sec. 1.301-1(1) provides that, even if a distribution to shareholders with respect to their stock is concurrent with another transaction such as a merger, recapitalization, or reincorporation, it will be treated as a distribution under sec. 301 if, in substance, it is a separate transaction.

**Leading Case**

The leading case in this area, *Bazley* (1947), preceded the insertion into the Code of sec. 354(a)(2) (making securities received in a reorganization boot), and reg. secs. 1.331-1(c) and 1.301-1(1).

The Supreme Court in the *Bazley* case held that an exchange by the shareholders of a family corporation of all the corporation's stock for new common stock and debenture bonds payable in ten years but callable at any time was not a recapitalization; the shareholders were required to treat as dividend income the fair market value of the debentures received.

In reaching its decision, the Supreme Court considered a number of factors, such as the liquidity of the debentures received, the business reasons for the "recapitalization," the unity of interest and control of the shareholders, and the pro rata character of the distribution. The Supreme Court did not indicate any one factor as being determinative but rather seemed to consider the net effect the transaction had on the corporation and its shareholders.
Recommendations

The basic theory of the Bazley case has been incorporated into reg. secs. 1.331-1(c) and 1.301-1(1). Since the final decision in each case is a question of fact upon which no specific guidelines can be given, no recommendations are being made for revisions to the existing regulations.

Carryover Problems Caused by Sec. 356(a)(2)

When additional consideration, or boot, is received in what otherwise would be a tax-free exchange under sec. 354 or 355, the gain, if any, to the recipient is recognized to the extent of the boot (sec. 356(a)). If the exchange has the effect of the distribution of a dividend, the recognized gain is ordinary income to the extent of accumulated earnings and profits (sec. 356(a)(2)). The question then arises regarding the proper charge to earnings and profits when dividend treatment is limited under sec. 356(a)(2).

Both the Commissioner and the courts have taken the position that the correct charge to earnings and profits for the amount of boot received is the amount taxed to the shareholders as dividends. However, this approach is not entirely logical, may create unfairness among the shareholders in the treatment of future distributions, and does not give adequate consideration to the fact that it may be impossible for the corporation to determine the amount of gain each of its shareholders had to recognize on his receipt of boot.
Current Status of the Law

Code and Regulations

When consideration is received in what otherwise would qualify as a sec. 354 or 355 exchange, under sec. 356(c), no loss will be recognized. Gain will be determined by comparing the basis of the stockholder's entire holdings with the value of the stock and other property received and will be taxable to the extent of the boot (sec. 356 (a)(1)). If the sec. 356 distribution has the effect of a dividend, the shareholder recognizes the same amount of gain, but the gain will be taxed as a dividend.

Reg. sec. 1.381(c)(2)-1(c)(1) provides that, if pursuant to the plan of reorganization the transferor corporation distributes boot to its shareholders, "then the accumulated earnings and profits of the transferor corporation as of the close of the date of transfer shall be computed by taking into account the amount of the distribution which is properly chargeable to earnings and profits, regardless of whether such distribution occurs before or after the close of the date of transfer."

Leading Cases

The treatment of earnings and profits as a result of the distribution of boot seems to have arisen in only two cases. In Campbell (1944), the court, as an alternate basis for its decision, held that, since the cash distributed at the time of the reorganization exceeded the accumulated earnings, there was no carryover since there would have been a taxable dividend to the extent of accumulated earnings. The court seemed unaware of the provision
limiting treatment to the amount of the shareholder's gain. In Munter (1945), the Tax Court declined to find any decrease in earnings in the absence of any showing of what the shareholder's basis was. By the time the case arose, seventeen years had passed since the transaction, and it was probably impossible for the taxpayer to obtain that information. The Court of Appeals for the Third Circuit reversed, relying on the first ground for decision in Campbell, that is, that there is no carryover whenever a large proportion of the old shareholders receive cash for their shares. The Supreme Court rejected this theory but remanded rather than decide the question of how much should carry over. It did indicate that dividend taxation was a prerequisite to a decrease in earnings.

Revenue Ruling

The following fact situation laid the foundation for Rev. Rul. 56-345. Pursuant to a merger agreement, M corporation transferred substantially all of its assets to N corporation in exchange for N's voting stock plus a small amount of cash, the cash being distributed in lieu of fractional shares. The stockholders of M exchanged their stock for stock of the acquiring corporation. Subsequent to the reorganization and not pursuant to a preconceived plan, the latter corporation redeemed for cash 26 percent of the stock issued in the merger. Certain stockholders, receiving such cash, purchased stock of another corporation. The Commissioner held in Rev. Rul. 56-345 that the exchange of stock of the dissolving corporation for stock of the acquiring corporation and the later redemption of a part of the latter corporation's stock constituted
two separate and distinct transactions. Hence, the provisions of secs. 368(a)(1)(C) and (a)(2)(B) were not voided.

It was further held, under the provisions of secs. 354(a)(1) and 356(a)(1), that gain was to be recognized in the stock redemptions, but in an amount not in excess of the cash received. A portion of the gain not exceeding each distributee's ratable share of the earnings and profits of M was treated as a dividend. The earnings and profits of M as of the effective date of the reorganization, after giving consideration to the distribution of cash which was treated as a dividend (sec. 356(a)(2)), became earnings and profits of N corporation.

Commentary

Halperin (1963). In his article, Daniel Halperin opposes on the following three grounds the approach adopted by the courts and the IRS of charging to earnings and profits the amount taxed as a dividend to each shareholder in the exchange or distribution.

1. Since the corporation's capital account and the holder's basis in his shares are distinct concepts and unlikely to be equal in amount, it does not logically follow that a reduction in one calls for a corresponding reduction in the other.

2. The approach would result in unfair treatment in future distributions since the shareholders who had to treat as dividends the total amount of boot they received in the exchange or distribution would
in effect have acquired a proportionate interest in earnings and profits actually attributable to the shareholders whose gain, and therefore the amount taxed to them as dividends, was less than the boot received.

3. It may be impossible for the corporation to determine the amount of gain each of its shareholders had to recognize on his receipt of the boot and seems, therefore, unduly harsh to require the corporation to prove that its shareholders received amounts to be treated by them as dividends before such amounts may be charged against earnings and profits.

Recommendations

Earnings and profits should be decreased by the amount of boot which constitutes a dividend under sec. 356(a)(2). When dividend treatment is limited under sec. 356(a)(2), however, it is recommended that earnings and profits be reduced in the same manner as sec. 302 redemptions under sec. 312(e). The method of allocation between capital and earnings and profits under sec. 312(e) is more appropriately discussed later. This recommendation is intended only for legislative change or a change in the regulations to bring the nondividend boot of sec. 356(a)(2) within the provisions of sec. 312(e).
The general rules with regard to the allocation and inheritance of earnings and profits in connection with a nondivisive tax-free reorganization have been codified in sec. 381(c)(2). Two problem areas exist under these present rules.

One of these problems is whether the transferor corporation in a "C" reorganization must liquidate after the transfer in order for its earnings and profits to pass to the transferee under sec. 381(c)(2). Although such a liquidation is not necessary for the transaction to qualify as a "C" reorganization, if it continues to exist and its earnings and profits pass to the transferee under sec. 381(c)(2), it would be able to make distributions to its shareholders without dividend consequences.

The other problem in the area of the carryover of earnings and profits in connection with a nondivisive reorganization involves asset acquisitions by, or asset transfers to, subsidiaries. The difficulty in this area arises from the definition of "acquiring corporation" for purposes of sec. 381. According to the definition provided in the regulations, if the parent corporation acquires all the assets of a corporation for its voting stock and then transfers part of these assets to one of its subsidiaries or divides all of these assets in transfers to several of its subsidiaries, the parent corporation is considered to be the acquiring corporation for purposes of sec. 381; thus, although it retains none or only a portion of the assets of the transferor corporation, the parent receives all of the transferor corporation's earnings and profits.
Current Status of the Law

Code and Regulations

Sec. 381 provides that the earnings and profits, or deficit in earnings and profits, of the acquired corporation will be deemed to have been received or incurred by the "acquiring corporation" and that any deficit in earnings and profits of the acquired corporation may be used only to offset earnings and profits accumulated after the reorganization transfer.

Reg. sec. 1.381(a)-1(b)(2) states that only a single corporation may be the acquiring corporation for purposes of sec. 381. Under these regulations, if the parent company transfers to one of its subsidiaries all the assets of the acquired corporation that it received in the reorganization transaction, the subsidiary receiving these assets is considered the acquiring corporation; however, if the parent corporation transfers only part of the assets it received to one of its subsidiaries or divides the assets it received and transfers them to several of its subsidiaries, the parent corporation is considered the acquiring corporation.

Reg. sec. 1.312-11(a) states that

... if, for example, property is transferred from one corporation to another in a transaction under Section 351 or as a contribution to capital and the transfer is not followed or preceded by a reorganization, a transaction under Section 302(a) involving a substantial part of the transferor's stock, or a total or partial liquidation, then ordinarily no allocation of the earnings and profits of the transferor shall be made.

This portion of the regulations has been used effectively to support
the theory that the allocation of earnings and profits between corporations is proper.

**Leading Cases**

The leading cases in this area are Sansome (1932), Phipps (1949), and Snider (1955). The holdings in these cases with regard to the carryover of earnings and profits have been codified in sec. 381(c)(2). None of these cases, however, addresses either of the two problem issues in this area.

**Revenue Rulings**

Rev. Ruls. 68-358 and 73-552 support the view that the transferor corporation in a "C" reorganization may continue to exist and yet have all of its earnings and profits transferred to the acquiring corporation. In Rev. Rul. 68-358, the transferor corporation had transferred all of its assets in the reorganization while, in Rev. Rul. 73-552, the transferor corporation had only transferred "substantially all" of its assets; in both situations it was ruled that the acquiring corporation would succeed to all the items described in sec. 381.

**Commentary**

Katcher (1960). With regard to the first issue of whether the transferor corporation in a "C" reorganization must liquidate, Richard Katcher, in his article, discusses the problem and states his belief that, in situations where the acquired corporation in a "C" reorganization remains in existence the IRS would contend that this
corporation retains earnings and profits in an amount equal to any distributions it makes to its shareholders. Katcher makes no mention of his opinion of the proper treatment of this problem.

With regard to the meaning in sec. 381 of the term "acquiring corporation," Katcher agrees with the regulations under sec. 381 that provide that, if a parent corporation acquires the assets of a corporation for its voting stock and then transfers all these assets to one of its subsidiaries, the subsidiary should be treated as the acquiring corporation and thus receive the carryover of earnings and profits. However, he further believes that an allocation of the acquired corporation's earnings and profits should apply if the parent transfers only part of the assets to one of its subsidiaries and retains the remainder or if it divides the assets and transfers them to more than one of its subsidiaries.

Recommendations

It seems desirable that, if the transferor corporation in a "C" reorganization continues to exist after the reorganization, the earnings and profits of this corporation be allocated so that after the reorganization this corporation retains earnings and profits in the amount equal to the value of the assets it retains in excess of the amount of its outstanding liabilities. Since such treatment is not consistent with the provisions of sec. 381, however, this treatment could only be adopted by legislation amending the Code. It is recommended, therefore, that legislation be considered which would amend the Code to allow the earnings and profits to
follow assets and be split where the corporation whose assets were acquired remains in existence.

With regard to the definition of "acquiring corporation," it is recommended that the regulations be amended to include a provision defining this term to mean the corporation, or corporations, which ultimately receive the assets of the acquired corporation following the reorganization. The regulations should also provide for allocation of the earnings and profits based on the ultimate allocation of the assets. This allocation of earnings and profits should apply where there is a "C" reorganization with a partial drop down or even when the transferee disappears and the assets are transferred to two or more subsidiaries under drop-down provisions.

Allocation and Inheritance of Accumulated Earnings and Profits in Divisive Reorganizations

The rules with regard to the allocation and inheritance of earnings and profits in connection with a divisive reorganization have been set forth in reg. sec. 1.312-10(a). The rules with regard to the allocation and inheritance of a deficit in earnings and profits are contained in reg. sec. 1.312-10(c).

Although reg. sec. 1.312-10(a) provides for an allocation of earnings and profits between the distributing and the controlled corporation, reg. sec. 1.312-10(c) disallows any such allocation of a deficit in earnings and profits. Thus, if a corporation having a deficit in earnings and profits spins off one of its several separate
businesses into a newly created corporation, no part of the deficit may be allocated to the newly created controlled corporation even though the business now taken over by the new corporation contributed in whole or in part to creating the deficit.

Such inconsistent treatment also applies to corporate separations which do not qualify as reorganizations under sec. 368(a)(1)(D). Reg. sec. 1.312-10(b) provides for an allocation of earnings and profits in these transactions, subject to certain limitations; reg. sec. 1.312-10(c), however, prohibits any allocation of a deficit in earnings and profits.

Commentary

Katcher (1960). In his discussion of this problem in his article, Richard Katcher suggests that the Commissioner refused to permit an allocation of a deficit because sec. 312(h) only authorized an allocation of earnings and profits. He further points out that, where Congress intended specific treatment of deficits in earnings and profits, it specifically stated so, as in sec. 381(c)(2). Katcher, however, does not agree with such inconsistent treatment and expresses the need for a statutory correction of this matter.

Recommendation

It is recommended that the regulations be amended to provide that reg. sec. 1.312-10(a) and (b) also apply to deficits in earnings and profits.
Treatment of Past Errors in Current Earnings and Profits Computations of Prior Years

At the present time there is no statute of limitations with respect to the computation of earnings and profits. Because of the importance of knowing with reasonable readiness and definiteness the amount of earnings and profits of a corporation, this "open season" on the recomputation has created a great deal of uncertainty.

Current Status of the Law

Leading Cases

In the cases of Kaplan (1965), Gurtman (1965), and Alderson (1965), it has been established that correction of past errors is not available to those taxpayers for whom such errors had resulted either in the imposition of less-than-dividend tax liability or of no tax liability whatsoever.

In the Kaplan and Gurtman cases, amounts claimed by the taxpayers as being loans from their wholly owned corporations were determined by the Commissioner to be dividends; the taxpayers, however, were not permitted to reduce the earnings and profits of their corporations for similar payments received by them in past years since they had treated these payments as loans and, therefore, had paid no tax on their receipt. The Alderson case reached a similar result involving payments treated by the taxpayers as being received under an installment sale and determined by the Commissioner to be dividends.
Revenue Procedures

Under Rev. Proc. 65-10, there is no statute of limitations with respect to earnings and profits. This is true whether the reason for the change is a court decision, an error on the books, an error on the tax return, a change in IRS policy, or any other reason. This is also true whether or not the statute has run on the stockholder's tax liabilities.

Rev. Proc. 75-17 updates and restates the instructions and guidelines contained in Rev. Proc. 65-10. The lack of a statute of limitations with respect to earnings and profits remains with us.

Commentary

Korbel (1965). In his article, Herbert J. Korbel discusses the cases that have held against the recomputation of earnings and profits by taxpayers when the recomputation would have resulted in a decrease in earnings and profits and no tax had been paid by the taxpayers on the initial transaction. He points out that, although such taxpayers cannot avail themselves of retroactive recomputations, there is reason to believe that the courts would permit the Commissioner to invoke such recomputations even if the IRS might thereby obtain a double benefit. He therefore suggests that a statute of limitations be established with respect to the computation of earnings and profits.

Recommendations

No recommendations are made at this time.
Problems in Earnings and Profits Resulting From Change in Ownership

A question has been raised whether events after a change of ownership, but within the same fiscal year, should affect a distribution made to a prior stockholder. For example, a distribution may be made at a time when there are neither current nor accumulated earnings and profits. However, if a change in ownership occurs, and the new management causes the corporation to realize current earnings and profits before the end of the taxable year, the distribution becomes taxable as a dividend. The fairness of this situation has been questioned.

Current Status of the Law

Legally, there is no question that, in determining current earnings and profits, the entire taxable year is taken into account as a whole.

Recommendation

This situation does not seem to generate inequities, either of a nature or of an amount sufficient to warrant remedial action. No need is seen to superimpose change of ownership concepts upon an already complex area.
CHAPTER 2: SALES OF HIGH-BASIS, LOW-VALUE ASSETS TO REDUCE EARNINGS AND PROFITS

A corporation may have large amounts of unrealized depreciation on either securities or other assets. These assets may have been written down for financial statement purposes, but no tax deduction has ever been allowed. The question arises as to whether judiciously timed sales of these depreciated assets can be used to decrease either current or accumulated earnings and profits in order to make possible distributions which are not taxable as ordinary income.

Current Status of the Law

It seems clear that a net capital loss, even though unallowable for federal income tax purposes, nevertheless reduces earnings and profits. Accordingly, there is no bar to tax planning based upon this principle.

Commentary

The interplay between current and accumulated earnings and profits has been a time-honored tax planning device. Some years
ago, one notable example was Pennroad Corporation (now Madison Fund, Inc.), which converted distributions from annual income for accounting purposes into a return of capital distribution by selling off depreciated railroad securities which produced the requisite amount of loss. Other planning devices include the action of holding companies which have accumulated deficits in receiving income in one year (which does not eliminate the accumulated deficit) and then making distributions in the subsequent year when no income is received. This, too, achieves return of capital treatment.

It is to be noted that the rule under which a dividend results from a distribution out of current earnings and profits originated in 1936 as a benefit to corporations because, in the situation of an accumulated deficit, it would have been impossible to make distributions taxable as a dividend (which was the only type of distribution which qualified to reduce the basis for the then-existing undistributed profits tax). For such a short-lived benefit, the current earnings rule has created almost 40 years of grief and complexity.

Recommendation

In view of the above comments, no remedial suggestion is made with respect to this problem.
CHAPTER 3: DEDUCTIBILITY OF ITEMS IN COMPUTING EARNINGS AND PROFITS

Many items not deductible for income tax purposes are nevertheless deductible in ascertaining corporate earnings and profits.

Commentary

It must be noted that the expenditures or losses which are nondeductible must not give rise to the basis of assets. Thus, for example, if an expenditure is disallowed as a deduction for income tax purposes because it is chargeable to capital (and therefore not deductible under sec. 263), no deduction of earnings and profits results. It is essential that the transaction result in no future tax effect. Also, losses which are reflected in the basis of assets (such as a nonrecognized loss on a reorganization) do not fall in this category.

A list of items falling under this category would probably be quite lengthy. Some items which readily come to mind include the following:

1. Net capital losses;

2. Contributions in excess of the 5 percent limitation;
3. Expenses and interest relating to tax-exempt income;
4. Unsubstantiated or otherwise unallowable entertainment expenses;
5. Business gifts in excess of permissible limits;
6. Business expenses in excess of amounts "ordinary and necessary";
7. Gambling losses in excess of gambling gains;
8. Amounts paid in connection with certain insurance contracts;
9. Bad debts owed by political parties;
10. Amounts paid to influence legislation;
11. Amounts not deductible by reason of sec. 279 (relating to corporate acquisition indebtedness);
12. Federal income taxes; and
13. Foreign income taxes used as a credit (not including taxes deemed paid under sec. 902).

Recommendation

No need is seen to make any changes with respect to the above rule.
The sections of the law regarding adjustments to be made in determining earnings and profits on distributions in property, including stock distributions, are to be found in secs. 305, 311, 312, and 355. The problems encountered in making such determinations arise primarily in areas of assignments of rights to income, bargain sales to shareholders, distributions of a company's own stock and stock rights, corporation separations and priority rules when cash and property distributions are made in the same year (the latter problem is discussed in another portion of this study).

Current Status of the Law

Code and Regulations

In general, under sec. 311(a)(2), no gain or loss is generally recognized to a corporation on distribution of property or stock with respect to its stock, including stock redemptions. The earnings and profits of a corporation are decreased by the adjusted basis of the property distributed. In those situations where gains are recognized, the corporation's earnings and profits will be increased by the gain less income taxes thereon and reduced by the adjusted basis of the property distributed. There are special rules for reducing earnings and profits on distributions
related to corporation separations.

Gain will be recognized under sec. 311 with a corresponding increase in earnings and profits on distributions of the following types:

1. LIFO inventory with gain recognized in amount by which FIFO or other basis exceeds LIFO basis;
2. Property where the shareholder assumes liability of corporations, with gain recognized to the extent liability exceeds the adjusted basis of the property. Where property is subject to liability which is not assumed, gain is limited to the excess of the fair market value of the property over the adjusted basis; and
3. Installment obligations with gain recognized pursuant to sec. 453(d).

Gain will also be recognized in the following situations:
1. Under the depreciation recapture provisions of secs. 1245 and 1250;
2. With respect to distribution of appreciated depreciable property;
3. Under the farm recapture provisions of secs. 1251 and 1252;
4. Under the investment credit recapture provisions of sec. 47(2)(1); and
5. On a distribution of sec. 341(f) assets by a collapsible corporation.
Stock redemptions. Sec. 311(d) provides for recognition of gain upon the use of appreciated property to redeem a corporation's stock in the amount that the fair market value exceeds the adjusted basis. Gain will be recognized to the corporation even though the distribution is essentially equivalent to a dividend. There are seven exceptions to this rule, which are summarized as follows:

1. Complete redemption of a ten percent shareholder for the prior 12 months;
2. Distribution of stock or obligations of a 50 percent-owned corporation within the one-year period following a nine-year period during which any control existed;
3. Distributions before December 1, 1974, of stock of a corporation the assets of which were held by the distributing corporation on November 30, 1969;
4. Antitrust distributions;
5. Sec. 303 distributions;
6. Certain private foundation distributions; and
7. Distributions by regulated investment companies.

Also, sec. 311(d) does not apply to complete or partial liquidations.

Sec. 355 separations. On sec. 355 separations in which gain or loss is not recognized to the corporations, the allocation of earnings and profits is discussed in the regulations. As previously stated, in a distribution pursuant to a divisive
reorganization within the meaning of sec. 368(a)(1)(D), the allocation is generally in proportion to the fair market value of assets retained and distributed (reg. sec. 1.312-10(a)). Alternatively, in the proper case, allocation is in proportion to the net basis of assets transferred and assets retained, or by other appropriate method.

In a spin-off of stock of an existing controlled corporation not covered by sec. 368(a)(1)(D), the earnings and profits of the distributing corporation are decreased by the lesser of (1) the amount computed under the "D" rule, or (2) the net worth of the controlled corporation on tax basis. The earnings and profits of the controlled corporation are increased, if necessary, to equal the amount of the above decrease, immediately before the transfer, pursuant to reg. sec. 1.312-10(b).

**Distributions of corporate stock or other property.** Under sec. 312(d)(1), distributions by a corporation of its stock, securities, stock rights, or other property do not affect earnings and profits if the distribution is nontaxable to the distributees (under sec. 305(a) or other section). A stock dividend taxable under sec. 305(b) is treated as a distribution under sec. 301 and reduces earnings and profits by their fair market value (reg. sec. 1.312-1(d)). A distribution by a corporation of its obligations reduces earnings and profits by their principal amount, pursuant to sec. 312(a)(2). Subsequent satisfaction of the obligations by a different amount will affect earnings and profits.
Where a corporation distributes appreciated inventory (that is, ordinary) assets to its shareholders, earnings and profits are increased by the appreciations and then decreased by the lesser of the fair market value of the assets or earnings and profits (as increased), pursuant to sec. 312(b).

Reg. sec. 1.316-1(a)(2) provides that, where a corporation distributes property to its shareholders, the dividend may not exceed its earnings and profits.

Bargain sales. On bargain sales by a corporation to a shareholder, earnings and profits are decreased by the excess of the basis over the sales price (reg. sec. 1.301-1(j)).

Leading Cases

Anticipatory assignment of income and imputed income. In one of the few cases in this area, Bacon McMillan Veneer Co. (1930), the corporation declared a 50 percent dividend. It paid the dividend by distributing liberty bonds of sufficient value. The Board of Tax Appeals held that the corporation was taxable on the appreciation in the bonds since it was paying a fixed obligation.

In Bittker and Eustice (1971, pp. 7-42) it is stated that the status of this case is not entirely clear under the 1954 Code. On the one hand, it can be argued under the general rule of sec. 311(a) that the corporation is not taxable on the distribution. On the other hand, since a fixed obligation has been satisfied, it may also be argued that the corporation should be taxed. Of course, this problem is easily avoided by not fixing an amount in the dividend resolution and instead merely referring to the property.
In Court Holding Company (1945), the taxpayer reached an oral agreement to sell its properties to a third party. The corporation then distributed the properties in a liquidation distribution to its shareholders, who then sold the properties to the proposed purchaser. It was held that, in effect, the sale was made by the corporation and should be taxed to the corporation. The formalities of the distribution to the shareholder were merely designed to disguise the value of the transaction.

Court Holding is not negated by the later adoption of sec. 311. That section holds that a distribution in kind to shareholders is not per se taxable to the corporation. It does not permit a corporation to avoid taxability by effecting a sale under cover of a distribution to its shareholders.

In First State Bank of Stratford (1948), the Fifth Circuit taxed the corporation on the following facts. The corporation made dividend distributions to its shareholders of notes which it had written off as bad debts. The shareholders subsequently collected the notes. The court held that the corporation realized income as collections were made. The bad debt write-off had resulted in a tax benefit to the corporation and had converted the notes from capital assets into pure potential income, which the corporation then assigned to its shareholders. The court held:

Under the anticipatory assignment of income note ... subsequent collection must be treated as if the bank had thereby realized income.... Such use of a dividend in kind, where the property distributed represents potential income, is an economic gain to the corporation in the amounts collected less recoveries for which no tax benefit has been received.
In Cumberland Public Service Company (1950), the courts were again confronted with the question of whether a sale of properties was made by the corporation or its shareholders. On the facts, it was found that the shareholders made the sale; they could have sold their stock, but instead they chose to liquidate the corporation and sell its properties. The shareholders were not a mere conduit for a sale by the corporation, and the fact that a major motive was to reduce taxes does not bar the conclusion. The decision stated:

The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern.... Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate.

In Lynch (1951), the corporation distributed its inventory of apples to its shareholders as a dividend in kind. However, the apples remained in the corporation's warehouses until they were sold a month later by the corporation for the account of the shareholders. Somewhat surprisingly, from the standpoint of tax logic, the district court held that the corporation was not taxable on the sale. The Ninth Circuit reversed, saying:

It is clear that the shareholders caused the dividend to be declared in the knowledge and expectation that the property distributed would be sold immediately.... Under these circumstances, we fail to see a motive for the dividend other than to escape taxation.... The dividend in question was not the kind of a distribution contemplated by the statute ... and must be ignored for tax purposes.

In connection with the adoption of sec. 311(a), the Senate
Report regarding its adoption (No. 1622), states that "your committee does not intend to change existing law with respect to attribution of income of shareholders to their corporation," and cites First State Bank of Stratford as an example. In Bittker and Eustice (1971, p. 7-42), it is suggested that this creates uncertainty about the scope of sec. 311(a), and that the rule of the Lynch case may perhaps have survived.

In A.B.C.D. Lands, Inc. (1964), a corporation paid a dividend to its shareholders from 1958 to 1961 by transferring to them legal title to standing grain crops. The shareholders then negotiated the sale of the crops. The IRS sought to tax the sale to the corporation on two alternative theories. One, the sale was in substance made by the corporation; or two, the distribution was an anticipatory assignment of income. Comparing the case to Lynch, the court taxed the corporation, saying:

Upon consideration of all the circumstances involved, it is clear that we have before us an attempt by a going concern to avoid the corporate income tax on the sale of its inventory by the annual ritual of a paper transfer of such inventory to its shareholders, followed closely by the sale of such inventory in the ordinary sense.

The fact that the Senate Reports on sec. 301 mentioned the continued validity of Stratford, but did not mention Lynch, did not mean that Lynch had been legislated out of existence.

In Harry H. Hines, Jr. (1973), the circuit court refused to impose a tax at the corporate level on a distribution in kind. In this case, the corporation owned timberlands, which were capital assets with a basis of about $40,000 and worth much more. However, the corporation had an accumulated deficit. In 1964-65, many large
timber companies showed an interest in purchasing the properties, but no agreement was reached. In 1966, the corporation distributed the lands to its shareholders. They negotiated with the interested parties and sold the lands for about $2,500,000, claiming long-term capital gain treatment.

The IRS maintained that the sales should be imputed to the corporation because the distribution lacked a normal and justifiable commercial motivation and was made for the principal purpose of avoiding tax. The corporation achieved earnings and profits, and the distributions to the shareholders were largely dividends. Hines, one of the shareholders, paid the resulting deficiency and sued for refund in the district court. The court found that the corporation did not negotiate the sale and that the shareholders were free to make their own deals. However, the primary purpose of the distribution was the avoidance of double tax. Therefore, the district court imputed the sale to the corporation.

The Fifth Circuit reversed, stating:

The starting point of our analysis is the Internal Revenue Code itself. Under Section 311 of the Code, as enacted at the time of the transaction we here review, gain was ordinarily not realized by a corporation that distributed property to its shareholders. Section 311 was not, however, intended to alter the law regarding the imputation of gain to a distributing corporation from a sale of distributed property by the corporation's shareholders when the corporation actually participates in the transaction in which the distributed property is sold.... The government argues that imputation was nonetheless proper because subsequent case law indicates that the imputed income rule must apply even where there are not predistribution sales negotiations, if the transfer was made (1) by an on-going concern (2) in anticipation of a sale by the shareholders,
and (3) with no valid business purpose aside from motives of tax avoidance. We cannot agree.... We hold that the sine qua non of the imputed income rule is a finding that the corporation actively participated in the transaction that produced the income to be imputed.

Peeler Realty Company (1973), is the companion case to Hines. Peeler was the corporation in which Hines was a shareholder. It filed suit against the IRS finding that it should be taxed on the sale of the timberlands. The Tax Court held for the taxpayer for two reasons: One, because it was bound by the Fifth Circuit's finding in Hines under the Golsen theory; and two, on the substantive merits. The court discussed two theories—imputed income and anticipatory assignment of income—which might affect the corporation's taxability. It held that under either theory the corporation was not taxable on the timberlands sale.

The imputed income theory focuses on the role of the corporation. The doctrine of anticipatory assignment of income concentrates on the type of asset which the corporation is distributing to its shareholders. The corporation could not be taxed on imputed income because it did not participate in the sales negotiations. Neither could it be taxed on anticipatory assignment of income. The timberlands were merely appreciated properties. They were not income ready to be recognized without further significant effort by the owner.

Distributions of corporate stock or other property. One of the most recent cases in this area is H. H. Robertson Company (1972, aff'd 1974). It involved the liquidation of RH, a United
Kingdom corporation. One of the issues was the amount by which the earnings and profits of RH were reduced by a dividend in kind paid in the preceding year. The court held unquestionably that, under sec. 312(a)(3) and as exemplified in the Senate Reports, earnings and profits are reduced by the adjusted basis of the property distributed. The case is of some interest because the taxpayer tried to argue that the principle of General Utilities and Operating Company (1936) would prevent this result. The court noted, however, that the government was not attempting to tax the distributor corporation on appreciation. The issue was the amount of the reduction of earnings and profits.

Bargain sales. The early leading case in this area is W. G. Maguire & Co., Inc. (1953). The taxpayer was a shareholder in Mokan Corporation, which owned stock in Panhandle with a basis of $47.86. In 1944, when Panhandle had a fair market value of $40, Mokan issued rights to its shareholders to buy at $30. Under this arrangement 151,958 shares of Panhandle were purchased. The court held that the difference between the cost of $47.86 per share and the fair market value of $40 per share was a transaction similar to a sale. For purposes of computing earnings and profits available for dividends, the $7.86 per share was deductible. The $10 difference between sales price and fair market value represented a distribution to shareholders. However, this was a return of capital, not a dividend, since the $7.86 deduction eliminated the corporation's earnings and profits.

It is not altogether clear, but apparently the $7.86 loss was not charged against taxable income, nor was it treated as a
capital loss carryover.

In Honigman (1971), the Maguire approach was changed. The Honigmans purchased a hotel from National, a corporation in which they were shareholders. The hotel had an adjusted basis of $1,468,169 to National and a fair market value of $830,000. The purchase price was $661,280. The Tax Court held that the Honigmans had a dividend to the extent that fair market value exceeded the price paid and also, citing Maguire, held that National was entitled to deduct as a loss the difference between the adjusted basis and the fair market value.

The Sixth Circuit modified this decision. It held that the adjusted basis of the hotel must be prorated to the dividend and to the sale. The fraction applicable to the sale portion is 661,280/830,000. The fraction applicable to the dividend portion is 168,720/830,000. These fractions are applied to the adjusted basis, $1,468,169. As to the dividend portion, presumably earnings and profits are reduced by the prorated adjusted basis, but are not affected by the excess of fair market value over adjusted basis. Therefore, the Honigman approach seems to be quite different from Maguire.

Revenue Ruling

Regarding distributions of corporate stock, Rev. Rul. 70-521, involved a situation where corporation X owned 50 percent of the stock of corporation Y. It distributed to its shareholders rights to purchase Y stock below market. The IRS ruled that the distribution was a taxable dividend but, pursuant to sec. 312(a)(3),
earnings and profits of X were not reduced, since the rights had a zero basis to X.

Commentary

Rabinovitz (1969). In his article on nonliquidating distributions in kind, Joel Rabinovitz notes that, where the distribution itself produces earnings and profits because gain is required to be recognized or because of sec. 312(b), an interesting allocation question may arise concerning the tax treatment of the shareholders. For example, X corporation, which has neither current nor accumulated earnings and profits apart from those produced by current distributions, distributes $100 cash to A and equipment worth $100 to B. The equipment has an adjusted basis of $50 and a recomputed basis for sec. 1245 of $100. Did A receive a dividend, and how much?

The author suggests that it is preferable to allocate the dividend between A and B rather than solely to B. Regarding the amounts allocated, however, he admits that the answer is not entirely clear and places it beyond the scope of his discussion. He further states that earnings and profits, before being reduced by virtue of the distribution, must be increased by the amount of any consideration received by the distributing corporation.

Rabinovitz also discusses adjustments to earnings and profits to reflect a property distribution in which the corporation realizes gain. For example, a corporation distributes unimproved realty with an adjusted basis of $50 and a fair market value of $100, subject to a mortgage of $75. The corporation has taxable
gain of $25, subject to income taxes of $6. As an undisputed corollary, predistribution earnings and profits are increased by $19, the gain recognized less the tax. Sec. 312(a) provides that earnings and profits should be decreased by the adjusted basis of the property distributed. How much? Logically, it would seem that the adjusted basis is $75—$50 original basis plus $25 taxable gain. This does not result in earnings and profits of $119, however, as shown in the table below. Rabinovitz concludes that the adjusted basis of $50 must be used for purposes of sec. 312(a), if the adjustments to earnings and profits indicated in sec. 312(c) and reg. sec. 1.312-3 are to give a logical result—earnings and profits of $119.

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<td>Predistribution earnings and profits</td>
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<td>Gain recognized—sec. 311(c)</td>
<td>25</td>
<td>25</td>
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<td>(6)</td>
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<td>75</td>
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<td>Adjustment for gain recognized—sec. 312(c)</td>
<td>(25)</td>
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<td>Earnings and profits after giving effect to the distribution</td>
<td>$119</td>
<td>$94</td>
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Rabinovitz points out that, in the absence of sec. 311(c), which results in a $25 taxable gain to the corporation in the above example, it would probably be more logical to treat the transaction as partly sale ($75) and partly dividend ($25). The cost to be
offset against the $75 sale would be $37.50. (This was the approach adopted three years after Rabinovitz wrote this article, in the Sixth Court's decision in Honigman (1972). However, Honigman involved a bargain sale at a loss where the fair market value was less than the cost.)

As a further illustration, X corporation has land with a basis of $100 and a fair market value of $75. Shareholder A takes it for a consideration of $75—either cash or assumption of liabilities. In this situation, Rabinovitz suggests, the corporation would have a tax-deductible loss of $25. The nonrecognition provisions of sec. 311(a) would not apply. A is taking as a third party, not as a shareholder, since he is paying fair market value. However, the loss, although recognized, may be disallowed in computing taxable income under sec. 267 or 1211. It would still, however, reduce earnings and profits under reg. sec. 1.312-7(b).

If A pays consideration of $50 when the fair market value is $75 and the basis is $100, the transaction is considered a bargain sale to a shareholder. Does the corporation have a $25 loss for income purposes, or does sec. 311(a) bar the loss for income purposes and, consequently, also for earnings and profits purposes? To answer these questions, Rabinovitz discusses the Maguire decision (which held that earnings and profits, although not taxable income, are reduced by the loss), but is not satisfied with it, contending that its rationale is not clearly articulated. On balance, Rabinovitz feels that the loss should not reduce the year's earnings and profits. He once again suggests that, as a matter of logic, basis should be apportioned between sale and distribution.
This suggested approach is inconsistent with reg. sec. 1.1001-1(e), which provides that, where a transfer is partly sale and partly gift, the sales price is offset against the total basis—the basis is not apportioned. It should be noted that reg. sec. 1.1011-2, reflecting the Tax Reform Act of 1969, provides that the basis be apportioned on a charitable bargain sale.

While conceding that it may require some liberties with the literal language of the statute and regulations to reach this result, Rabinovitz would adopt an approach whereby the effect on earnings and profits would be made uniform with respect to the recognition and nonrecognition distributions.

Jacoby (1971). In dealing with distributions of taxable stock dividends, Richard A. Jacoby observes that it is clearly settled that earnings and profits are reduced by the fair market value of taxable stock dividends even though it would seem to be improper since there is no diminution in corporate assets (reg. sec. 1.312-1(d) and legislative history). Nevertheless, he contends, a case could be made for this approach on a symmetrical basis, that is, the shareholder is taxable on the value. But where the fair market value exceeds book value, earnings and profits in the end are reduced by unrealized values.

The author notes that, although sec. 312(d) states that there is no earnings and profits reduction on nontaxable distributions of stock, securities, or other property, the section does not affirmatively state that earnings and profits will be reduced if a transaction is taxable to the distributee. This appears to
be the rationale for Rev. Rul. 70-521 holding no reduction in earnings and profits on distribution of taxable stock rights since they had no basis to the distributing corporation. Nevertheless, a newly issued stock dividend taxable under sec. 305 also has no basis and yet reduces earnings and profits by its fair market value.

There appears to be a conflict between the legislative history and the cited regulation section and the general rule under sec. 312(a), that a distribution of property reduces earnings and profits by adjusted cost, not fair market value.

Minneapolis Law Review (1970). A note in the Minneapolis Law Review indicates that gain recognized in sec. 311(d) distributions will be capital or ordinary depending on the nature of the property distributed. The corporation's earnings and profits account will also be increased by the gain.

Although it frequently employs the term, the author states the Code fails to provide a precise definition of earnings and profits or how to compute them, merely stating instead the effect of certain transactions on earnings and profits. The courts also have failed to develop a precise definition, and have merely constructed a framework within which to proceed.

Since the earnings and profits of a corporation are adjusted by the gain recognized under sec. 311(d), any gain recognized by the corporation under sec. 311(d) would be included in the corporation's earnings and profits before the general rule of sec. 312(a) regarding the decrease of a corporation's earnings and
profits is applied. This apparent simultaneous increase and
decrease in the earnings and profits account, however, can have
substantial tax consequences to an individual shareholder if the
corporation has no other earnings and profits. Reg. secs. 1.312-3 and -4 adds vague support to this analysis.

The author notes that sec. 311(a) does not relieve the
distributing corporation from paying tax on income properly
attributable to the corporation but received by its shareholders
as a result of an otherwise nontaxable distribution. He cites
Senate Report No. 1622 and reg. sec. 1.311-1(a), which states:

The proceeds of the sale of property in form
made by a shareholder receiving such property
in kind from the corporation may be imputed to
the corporation.... Moreover, where property
is distributed by a corporation, which distribu-
tion is in effect an anticipatory assignment
of income, such income may be taxable to the
corporation.

Recommendations

There is a recognition of a basic accounting principle
that earnings and profits should be reduced by the actual amount
(for tax purposes) that the corporate assets have been diminished.

Amounts to be charged to earnings and profits on corporate
distributions should depend neither on the taxability to the share-
holder nor on whether the shareholder is an individual or corpora-
tion. Where no diminution of corporate assets resulted from the
distribution, as in the case of stock dividends or stock rights
distributed to shareholders, it is recommended that there be no
reduction in earnings and profits. On distribution of corporate
assets, the charge to earnings and profits should be limited to the tax basis of the property distributed, increased by any gain (or reduced by any loss) recognized on the distribution to the distributing corporation. On a spin-off, whether or not as part of a sec. 368(a)(1)(D) reorganization, the earnings and profits on the spun-off corporation would be equal to the charge made to the distributing corporation's earnings and profits.

Regarding sales of property to its shareholders, the earnings and profits would be increased or reduced by the difference between the tax basis of the property sold and the proceeds received.

It is felt that the above approach is equitable and will considerably simplify the complex rules which have evolved. There will be no need on the corporate level for determination of fair market values with respect to property distributions.
Construction of Sec. 312(e)

The law regarding adjustments to be made to earnings and profits as a result of secs. 302(a) and 303 redemptions and partial liquidations is set forth in sec. 312(e). This section states that the portion of any such distributions which is "properly chargeable to capital account shall not be treated as a distribution of earnings and profits." Two major issues arise when trying to interpret this phrase—what method is to be used to determine the amount which is "properly chargeable," and what the term "capital account" encompasses.

Current Status of the Law

Code and Regulations

As stated above, under sec. 312(e), in the case of amounts distributed in a partial liquidation or in a redemption to which sec. 302(a) or 303 applies, the part of such distribution which is properly chargeable to capital account is not treated as a distribution of earnings and profits. In addition, reg. sec. 1.312-5 has a special rule for partial liquidations and certain redemptions. It states:

The part of the distribution properly chargeable to capital account within the provisions of Section 312(e) shall not be considered a
distribution of earnings and profits within the meaning of Section 301 for the purpose of determining taxability of subsequent distributions by the corporation.

Leading Cases

The two leading cases in this area, Jarvis (1941), and Woodward Investment Co. (1942), are primarily concerned with the method of allocation to determine the amount "properly chargeable" rather than with the definition of "capital account."

In Jarvis, a corporation redeemed one-tenth of its capital stock for $1,160,000. The court stated that the capital account of the corporation consisted of approximately $1,900,000, being the total of the par value of the stock and the paid-in surplus, and held that the balances in these accounts should be reduced by the percentage that the redeemed stock bore to all the company's outstanding stock--10 percent, or approximately $190,000. The difference between the total amount of the distribution of $1,600,000 and the $190,000 charged to the capital account was chargeable to earnings and profits.

The decision in Jarvis was followed in the following cases: Anderson (1976); Enoch (1972); Bennett, Jr. (1970); and Rice (1942).

The Woodward case involved one of a series of distributions made in complete liquidation to the corporation's sole shareholder. In this case, the capital account was considered to consist of the par value of the stock, paid-in surplus, earnings and profits from the period prior to March 1, 1913, and appreciation surplus.
The court held that the percentage of the distribution chargeable
to post-March 1, 1913, earnings and profits was equal to the
proportion that the post-March 1, 1913, earnings bore to the total
net worth of the company, that is, the capital account plus the
post-March 1, 1913, earnings and profits.

The decision in Woodward was followed in the following
cases: Shellabarger Grain Products Co. (1944) and Meurer Steel
Barrell Co. (1943).

Revenue Ruling

The IRS acquiesced in both the Jarvis and the Woodward
decisions in 1942 in GCM 23,460, stating that the two cases were
not inconsistent but merely differed because of the facts involved.
The Jarvis approach was applicable when the distributions in
redemption or partial liquidation were non-pro rata, while the
Woodward approach was applicable when the distributions were pro
rata. This was the position held by the IRS until 1970, when it
issued Rev. Rul. 70-531, which withdrew its acquiescence to Jarvis
and Woodward.

The facts involved in Rev. Rul. 70-531 dealt with a
redemption under sec. 302(a), but the ruling stated the principles
set forth were equally applicable to redemptions under sec. 303 and
partial liquidations under sec. 346. In this ruling, the IRS
stated:

... the proper charge to the capital account
includes not only the allocable portion of the
capital paid in for stock at its basis for Federal
income tax purposes but also the pro rata share of

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the other attributes including unrealized appreciation surplus of the corporation. The charge to earnings and profits is the pro rata portion of the total earnings and profits of the corporation thereof attributable to the shares redeemed.

Despite the fact that the IRS withdrew its acquiescence to the Jarvis decision in Rev. Rul. 70-531, this decision was cited as authority in Enoch for the court's decision as to both the definition of "capital account" and the method of determining the amount chargeable to that account.

More recently, the Tax Court in the Anderson decision upheld the taxpayer's computation, which used the Jarvis approach, and stated that the formula used was more consistent with the legislative history of sec. 312(e) than the formula set forth by the IRS in Rev. Rul. 70-531.

Commentary

Bittker and Eustice (1971). The following example by Boris Bittker and James Eustice aids in clarifying the problems involved in the interpretation of sec. 312(e) and the results obtained under the allocation methods of Jarvis, Woodward, and Rev. Rul. 70-531.

Facts: Assume that A and B each contribute $10,000 in cash to X Corporation in exchange for fifty shares of its stock, such shares constituting all of X's outstanding stock. X's original capital account thus would be the $20,000 paid in by A and B, whether their payments are allocated in full to the capital stock account or divided between capital stock and paid-in surplus. After X has earned and accumulated $10,000 after taxes, and when the "book value" of its stock is $30,000 (viz., the initial corporate capital account of
$20,000, plus accumulated earnings of $10,000 or the balance sheet net worth of the company) and its fair market value is $40,000, A's shares are redeemed for $20,000.

Under Section 312(e), if the Jarvis approach is used, X's charge to earnings and profits would be $10,000, computed as follows: the portion of the distribution chargeable to capital account is $10,000, that is, that portion of the capital account (total $20,000) which the number of shares redeemed bears to the total number of shares outstanding (50 percent). The balance of the distribution, $10,000, would be the amount chargeable to earnings and profits, and the account would thus be eliminated, even if A were accorded capital gain treatment on the distribution.

The Woodward formula, on the other hand, would apparently limit the earnings and profits charge to $6,667, namely, that portion of the distribution equal to the ratio of earnings to corporate net worth (in this case, $20,000 times $10,000 over $30,000).

Rev. Rul. 70-531 would give still another result here by limiting the sec. 312(e) charge to $5,000, the redeemed stock's ratable share of X's earnings.

The following are summaries of four of the articles concerning the effects of redemptions and liquidations on earnings and profits.
Edelstein and Korbel (1965). A comprehensive examination of Section 312(e), this article by Haskell Edelstein and Herbert J. Korbel, addresses itself to both the issue of determining the amount chargeable to the capital account and the issue of defining "capital account." The Jarvis and Woodward cases are discussed in detail, but since the article was written in 1965, there is no discussion comparing the methods used in these cases with the method advocated by Rev. Rul. 70-531.

The authors proposed two separate and distinct methods which they felt were based on the policies underlying sec. 312(e)—tax equity and minimization of bail-out.

Further, the authors proposed that the "capital account" should include the adjusted basis of property contributed to the distributing corporation. They left as an unresolved problem what the proper method of allocating the capital account to different classes of stock would be where proof of the historical source of the contributed property is lacking.

Edelstein (1971). The tax equity approach was summarized by Edelstein in this later article as follows:

The so-called "tax equity" approach ... in essence involved two interrelated and mutually dependent parts:

(1) The then existing earnings and profits should be reduced, at the time of redemption, only by the redeemed shares' pro rata portion thereof.

(2) The excess of the redemption price, over the redeemed shares' pro rata portion of capital account and earnings and profits, should be charged to a special "deferral account," which account would thereafter be offset and absorbed by
the share of future earnings and profits which would have been attributable to the redeemed shares if the redemption had not occurred.

One of the fundamental objectives of the "tax equity" approach is to put the remaining shareholders in the same position that they would have been in if there had been no redemption. The subsequent treatment of the so-called "deferral account" is, therefore, crucial to the achievement of that result. This obviously requires that subsequently realized earnings and profits not be increased by the portion actually distributed in anticipation of realization on the redemption.

The minimization of bail-out approach is based upon the premise that the depletion of earnings and profits upon a distribution which is not taxed as a dividend to the recipient should be hindered. This approach provides that terminal distributions should be charged first to the capital account, with any excess then being charged to earnings and profits.

Also in this article, Edelstein attacks Rev. Rul. 70-531 on the following three grounds:

1. Sec. 312(e) states that the amount chargeable to the capital account is to be determined first, with the balance of the distribution being charged to earnings and profits. The ruling, however, requires that the amount chargeable to earnings and profits be determined first, with the balance chargeable to the capital account.

2. The inclusion in the capital account of unrealized appreciation, as required by the ruling, is "unsupported by any judicial authority, and is
contrary to the tax basis balance sheet and logical consistency, which require that if it is excluded from earnings and profits, then it must also be excluded from capital account."

3. According to the legislative history, when Congress adopted sec. 312(e), it did so with the purpose of merely re-enacting the existing statutory law and the accompanying administrative practices. Thus, when the IRS revoked its acquiescence to Jarvis and Woodward and put forth the approach of Rev. Rul. 70-531, it went against Congressional intent.

Edelstein notes that the revenue ruling had adopted the first part of the tax equity approach that he and Korbel had advocated in their earlier article, but had ignored the second portion resulting in unfair treatment to the remaining shareholders.

Jacoby (1971). In this article, Richard Jacoby seems to be in agreement with Edelstein and Korbel's tax equity approach. He points out that a redemption price on liquidation value may be determined not only by book capital and surplus accounts but also by unrealized appreciation or depreciation which has not been recorded on the books. Such excess over book value resulting from unrealized appreciation should not reduce earnings and profits as provided for in Jarvis and Woodward since it had never been included in earnings and profits to begin with.
Jacoby goes on to agree with Edelstein that Rev. Rul. 70-531 is subject to criticism because it does not take into account the second part of the tax equity treatment—that is, that it does not make any adjustments to earnings and profits to reduce the amount of realized appreciation or depreciation ultimately recorded in earnings and profits by the amounts taken into account at the time of the distribution in redemption.

In addition, Jacoby points out another problem which Rev. Rul. 70-531 produced. If stock is redeemed for appreciated or depreciated property, the capital account and earnings and profits will be reduced under sec. 312(a)(3) only by the basis of such property; in accordance with the ruling, however, such property will be included in the capital account at a value which reflects the unrealized appreciation or depreciation. Neither the ruling nor the author provides any resolution for this problem.

Jacoby's final criticism of the ruling concerns pro rata partial liquidations. He states that, if a corporation sells one of its businesses and distributes the proceeds pro rata, the ruling would require that a portion of the distribution be charged to the unrealized appreciation in the remaining business. The author recommends that "the distribution should then be charged against capital, unrealized appreciation, earnings and profits, or other similar accounts only to the extent and in the proportion that those accounts stand behind the assets representing the discontinued corporate activities. Any excess could then be applied against the remaining balances in these accounts in accordance with the ruling" (p.661).
In contrast to the points of view expressed above, Jerry J. McCoy's article presents the following arguments in support of Rev. Rul. 70-531:

1. The application of sec. 312(e) under Jarvis and Woodward could result in tax avoidance in a number of situations, with the redemption of a few shareholders completely eliminating the earnings and profits account.

2. The approach of Rev. Rul. 70-531 does not necessarily always result in a benefit to the government; if the distribution is less than the share of paid-in capital and earnings and profits notably attributable to the redeemed shares, the charge to earnings and profits under the ruling would be lower than under the Jarvis or Woodward approaches.

3. The inclusion of unrealized appreciation and other similar attributes in the capital account is in agreement with many corporate statutes of several jurisdictions and with the regulations under sec. 562. Inclusion of these items in the capital account is necessary to prevent distortions that can result under the Jarvis and Woodward approaches, where the redemption of the shares of a few shareholders eliminates the earnings and profits account to the benefit of the remaining shareholders.
Although McCoy's article presents arguments in support of Rev. Rul. 70-531, he concludes by admitting that the ruling has raised many problems and that it is by no means the solution to the problem of interpreting sec. 312(e). He suggests as possible solutions either legislation to conform sec. 312(e) to sec. 312(a)(3), or legislation which would abandon the concept of earnings and profits as a means of distinguishing between income and return of capital.

Recommendations

It is recommended that the IRS position as announced in Rev. Rul. 70-531 be slightly modified. Application of this rule, as it presently exists, may result in treating the pro rata share of the unrealized appreciation, depreciation, or other attributes as part of the capital account. The recommended modification would charge this excess (or vice versa) of the redemption price over the redeemed shares' pro rata portion of the capital account to a special "deferral" or "suspense" account. The "suspense" debit or credit would then be amortized over a period of ten years.

This approach would eliminate the inequity created under Jarvis and Woodward, whereby the redemption of the stock of a few shareholders can eliminate the entire earnings and profits account to the benefit of the remaining shareholders. It would also eliminate the inequity created under Rev. Rul. 70-531, whereby the full amount of any realized appreciation, depreciation, or similar attributes is reflected in the earnings and profits account despite
the fact that some portion of this amount was taken into account upon the redemption or partial liquidation.

The above approach is illustrated by the following example, based on Jacoby (1971).

A and B form X corporation, each investing $50 for one half of the corporation's stock. Subsequently, when X corporation has $60 of earnings and profits and $40 of unrealized appreciation in the value of its assets, A's shares are redeemed for $100. As a result of this redemption, X corporation's capital account and earnings and profits account are reduced by A's pro rata share ($50 and $30, respectively). The excess of the redemption price of $100 over the $80 reduction in the capital and earnings and profits accounts of X corporation is charged to a deferral account. The excess in the deferral account would be amortized over a period of ten years by offsetting the $20 deferral account against the $40 of appreciation realized; the $20 balance of the appreciation over the deferral account will be the increase to earnings and profits resulting from the realization of the appreciation. The converse of this situation occurs when the redemption is made for less than the tax book value (pp. 657-8).
Premiums Paid Upon Redemption of Preferred Stock

A crucial question is posed by sec. 312(e): To what extent shall the redemption distribution, although subject to exchange rather than dividend treatment in the hands of its recipient, be treated as derived from earnings and profits so as to reduce that account accordingly? Specifically, is the premium portion of a distribution paid upon a redemption of preferred stock an amount properly chargeable to the capital account or a distribution of earnings and profits? This question has not been settled legislatively, but has been left to be interpreted by the judicial system.

Current Status of the Law

Code and Regulations

Sec. 312 is the operative provision which governs the effect on earnings and profits of distributions of corporate property made with respect to a company's stock. Pursuant to sec. 312(e), in the case of amounts distributed in partial liquidation or redemption, the part of such a distribution which is properly chargeable to the capital account cannot be treated as a distribution of earnings and profits.

Leading Cases and Revenue Rulings

Early rulings and cases dealt at least tangentially with the premiums paid upon redemption of stock. It is significant that, in each, only the par or stated value of shares redeemed above par was allocated to the capital account. Excess distributions
(for example, premiums paid on redemption), were held allocable to earnings, OD 479 (1920); IT 1802 (1923); and John B. Stewart (1934).

There followed in the wake of these rulings and cases a string of cases involving the deduction permitted certain corporations for dividends paid under sec. 562(b) and its predecessors. Under this section, amounts distributed in liquidation of certain corporations are "treated as a dividend" for the purpose of computing the dividends-paid deduction to the extent such amounts are properly chargeable to earnings and profits. Thus, in construing this provision, the courts were required to determine the proper account to which premiums paid on redemption were to be charged.

Here again, the courts agreed that the par value or capital standing behind the redeemed shares was chargeable to the capital account. Premiums, like dividends, were treated as properly chargeable to earnings and profits (J. Weingarten, Inc. (1941); F & R Lazarus & Co. (1942); Union Sugar Co. (1942); Rice (1942); Van Norman Co. (1944).)

There does not appear to have been recent activity in this area.

Commentary

Washing (1969). In discussing whether the call premium on preferred stock should be properly charged to earnings and profits, Thomas G. Washing asserts that the courts have been notably
consistent in refusing to treat the premium as a bona fide dividend, but allowing it to be charged to earnings and profits. If the premium were charged to capital, the remaining shareholders would suffer a diminution in their capital paid in and also would be involuntarily subjected to a future dividend liability greater than if no redemption had taken place. From an accounting standpoint, it is generally considered desirable to maintain the capital contributed intact. Thus, the SEC and leading accountants have taken the position that redemption premiums paid to preferred shareholders in excess of the amounts contributed by them should be charged to earnings and profits.

This rationale is also persuasive for tax purposes. The premium is essentially a conservatory payment for termination of the contract and forfeiture of future dividends, and thus, more akin to a dividend than a capital contribution. Since a dividend is by definition a distribution of earnings and profits, this rationale would indicate that the premium should be charged to earnings and profits.

Recommendations

Judicial and administrative precedents, as well as sound accounting practice, clearly require that a premium paid upon the redemption of preferred stock be charged to the earnings and profits of the distributing corporation. These precedents and the lack of any recent activity in this area would seem to indicate that no proposed Code or regulations revisions are necessary.
Neither the statutory language nor the court's *per curiam* opinion in *Baker* (1972), resolves the difficulty of reconciling the apparent conflict between the mandate of sec. 316(a)(2), which requires that no effect be given to any distribution during the year for the purpose of determining current earnings and profits, and the mandate of sec. 312(a), which seems to require that all distributions (including redemption distributions to the extent not chargeable to capital account), reduce that account as of the time the distribution is made. The latter rule is generally recognized in determining the effect of distributions on accumulated earnings and profits under sec. 316(a)(1) and the concluding paragraph of sec. 316(a).

While there is nothing in the statutory language to indicate whether, and how, the same rule might also be applied in determining current earnings and profits, Rev. Rul. 74-339 states that ordinary distributions take priority over redemption distributions in determining current earnings available for dividends. This solution to the problem, in effect, states that sec. 316 encompasses redemption distributions, which is inconsistent with the position held since 1928 that redemptions which qualify for "sale or exchange" treatment are not a "dividend" for purposes of sec. 316. In addition, Rev. Rul. 74-339 would require returns of capital
to be taxed as dividends.

**Code and Regulations**

Sec. 312(a) provides the general operation rule that there shall be a reduction on the distributions in the corporation's earnings and profits account upon all distributions by the corporation to its shareholders (including those in redemption), except insofar as sec. 312(e) requires that no such reduction shall be made in the case of a distribution in partial liquidation or redemption to the extent that such distribution is required to be charged to the capital account.

Sec. 316(a)(2) defines the term "dividend" as being a distribution out of earnings and profits of the taxable year (computed at the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

**Leading Case**

*Baker* is the sole court case concerning the priority to be applied in allocating the available current earnings and profits between a redemption distribution and the ordinary dividend distribution. In the *Baker* case, the corporation made two ordinary distributions to all of its shareholders during the year. Together these distributions exceeded current earnings (there were no accumulated earnings). In the same year, the corporation redeemed some shareholders' stock. The taxpayer claimed that the redemption
reduced current earnings before ordinary distributions were taken into account. The court held that ordinary distributions take priority in reducing current earnings and are taxable as dividends to extent of current earnings.

The Baker decision was followed in Anderson (1976).

Revenue Procedure and Revenue Ruling

Rev. Proc. 72-9 declares that rulings or determination letters will not be issued on sec. 312.

Rev. Rul. 74-339 states that, when both ordinary distributions under sec. 301 and redemption distributions under sec. 302 are made during the same taxable year and the combined distributions exceed earnings and profits for the year, the ordinary distributions take priority in determining current earnings available for dividends. Only current earnings in excess of the ordinary distributions are treated as available for redemption distributions.

Rev. Rul. 74-338 gives examples illustrating computation methods in a situation where the current year's earnings and profits exceed the ordinary distributions made and in a situation where the opposite occurs.

Commentary

Edelstein (1973) and Jones (1973). In their respective articles, Haskell Edelstein and John Andrew Jones are in general agreement with respect to the general conclusion of the Baker case and its apparent conflict with the Code. In general, the court in Baker, in seeking to determine the proper alternative to choose,
was faced with a lack of any clear direction in either the applicable statutory provisions or the legislative history. Accordingly, the court in substance based its conclusion on the approach that it would have been the intent of Congress (if Congress had been aware of the problem) to require that ordinary dividend distributions be given priority over redemption distributions in terms of the distribution of current earnings and profits to insure that current earnings are taxed as dividends to the greatest possible extent. The three judges could not agree on the proper analytical statutory basis upon which to ground the result. The decision was reached by majority vote, and even the two majority judges did not agree between themselves as to the bases for their conclusion.

The Baker case, in essence, concluded that the term "any distributions" (sec. 316(a)(2)) refers to any distribution which would, absent the phrase, reduce earnings and profits in accordance with the provisions of sec. 312(a). This interpretation is inconsistent with the position held since 1928 that redemption distributions which qualify for "sale or exchange" treatment do not come within the term "dividend for purposes of Section 316," so that such types of distributions are not encompassed within the meaning of "any distributions" as it appears elsewhere in sec. 316(a). The impact of the conclusion is that the term "distributions" has different meanings in different contexts within sec. 316(a) -- it excludes redemption distributions except where used in the parenthetical phrase in sec. 316(a)(2).

Neither sec. 312(a) nor 316(a)(2) specifically deals with the time or priority of the charge to earnings and profits between
ordinary dividends and redemption distributions. The only possible basis for a timing (but not a priority) rule in sec. 312(a) is the implication that the reduction in the earnings and profits account is to be made "on the distribution" (that is, at the time of the distribution).

Recommendation

A revision of sec. 316 is recommended. This proposed statutory revision presented below would eliminate the timing conflict between secs. 312(a) and 316(a)(2). Distributions would first be applied against current earnings and profits (the latter to be determined on either a pro rata or an actual basis). All distributions would be the same; that is, no distinction between pro rata and non-pro rata distributions would be made. This revision would, therefore, allow distributions under sec. 312(a) to continue to be charged to the earnings and profit account on the date of distribution regardless of whether the distribution is ordinary or in redemption or a partial liquidation.

The balance of the account as of the date of the distribution would be ascertainable at the end of the tax year and spread throughout the year on a daily pro rata basis; or, alternatively, this balance could be the actual balance computed at the time the distribution is made. Distributions would be taxed as dividends only if the corporation has a credit balance in the accumulated earnings and profit account at the time of the distribution. Thus, returns of capital would not be taxed as dividends, and no
priorities in reduction of earnings would be given to ordinary distributions.

Proposed Revision to Sec. 316

This proposed statutory revision assumes that the current earnings and profits are determined on a daily pro rata basis. The proposed revisions are, first, that sec. 316(a)(2) read simply "out of its earnings and profits of the taxable year"; and secondly, that the second paragraph of sec. 316(a) be revised to read as follows:

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. The current-year charge or credit to accumulated earnings and profits at a particular time is determined by allocating the entire year's gain or loss (calculated at the end of the year) on a daily pro rata basis. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which Section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.
Sec. 312(k) provides that, with certain exceptions, earnings and profits for any taxable year beginning after June 30, 1972, are to be determined by use of the straight-line method of depreciation, and not by reference to any accelerated method of depreciation actually used in computing taxable income. The section was directed primarily toward ending the return-of-capital distributions which were being made by public utilities and by real estate corporations. As a result of this enactment, numerous problems have arisen, including the following:

(1) A considerable record-keeping burden is placed upon corporations.

(2) Technical problems have arisen regarding the transfer of assets in connection with corporate organizations (sec. 351) and divisive reorganizations (sec. 355).

(3) Fall-out has occurred in areas where earnings and profits can represent unexpected pitfalls, such as subchapter S corporations, real estate investment trusts, and so forth.

In addition, the very targets of sec. 312(k) have in recent years fallen upon difficult times. Real estate is perhaps the hardest hit of all industries, and utilities are experiencing
difficulty in raising necessary equity capital because of the low value of their common shares.

Current Status of the Law

The regulations under sec. 312(k) do not provide any real interpretative assistance nor have there been any rulings or cases dealing with the section. Guidance, therefore, is provided only by legislative history.

Commentary

To furnish the information required by sec. 312(k) will require considerable effort. Such records are not maintained by most corporations in the ordinary course of business. Most corporations will not make such calculations until the amount of earnings and profits becomes relevant, at which time it may be too late to reconstruct the necessary information. This requirement will only lead to poor administration of the tax law and, consequently, inequities among various taxpayers. Moreover, now that it becomes clear that the national economy is not continuing to grow at recent historical rates, there will arrive a time in future years when the adjustment will not reflect too great a net amount.

Regarding technical problems, engaging in a sec. 351 transaction by a corporate transferor becomes extremely complex under circumstances in which property depreciated by an accelerated method is transferred. Although it is not clear, according to the committee reports, earnings and profits are to be adjusted
appropriately upon an ordinary sale of the property. Presumably an adjustment also takes place upon the conversion of the basis of such property into another asset, such as the stock of a controlled corporation which is a sec. 351 transferee. If such is not the case, it would create problems since earnings and profits would then not be reflected upon the books of the corporation which had reported for income tax purposes the items of depreciation and gain or loss (including depreciation recapture).

In the spin-off area, there is a question of what amount of earnings and profits (that is, with or without regard to sec. 312(k)) is to be apportioned between the distributing corporation and the corporation whose stock was distributed. This question becomes even more complex because the assets subject to accelerated depreciation may be retained, transferred to the distributed corporation, or otherwise spun off disproportionately.

Also to be considered is the new rule's effect on certain special entities. The new rule is particularly harsh with respect to subchapter S corporations, for earnings and profits can be accumulated there even though the corporation had elected subchapter S ever since its inception. Distributions out of these earnings and profits will result in dividend income to the shareholders even though there was no underlying taxable income to the corporation. In short, this is still one more exception to the general conduit principle of a subchapter S corporation. Parallel problems can exist in real estate investment trusts and personal holding companies. Even the $150,000 minimum credit for the purpose of the tax on improperly accumulated surplus imposed by sec. 531 is affected.
Recommendation

It is recommended that sec. 312(k) be repealed retroactively. In the light of the present low state of the utility and real estate industries, its 1969 purpose has become short-sighted. Moreover, utilities still make distributions which represent a return of capital. This may in part be attributable to the use of the "80 percent life" permitted by the asset depreciation range (ADR) system, which is not affected by sec. 312(k). Repeal of the section would lead toward greater simplification of a most complex area and would serve to establish once again that desirable relationship between methods of tax accounting and earnings and profits which has long been the general rule. Failing repeal, the Treasury should immediately promulgate regulations on the administration of sec. 312(k).
CHAPTER 8: DEDUCTIBILITY OF TAXES IN COMPUTING EARNINGS AND PROFITS

Uncertainty exists for both cash and accrual method taxpayers as to when taxes are to be taken into account in determining earnings and profits. The position of the cash basis taxpayer in deducting taxes is especially unclear, and the question arises as to whether the cash-basis taxpayer can deduct accrued federal income taxes in computing earnings and profits. In either case, the taxes may be disputed or undisputed. Conflicting precedents have turned this area into a veritable jungle.

Current Status of the Law

Leading Cases

A leading case allowing the taxes to be taken into account in the year to which the tax relates is Demmon (1963). Upholding the IRS position is Alworth Trust (1943). The cases which allow the tax to enter into earnings and profits also deal with disputed taxes as well. They are apparently decided on a basis of "fairness."

Revenue Rulings

For accrual method taxpayers, an undisputed federal income
tax creates no problem since the tax accrues at the close of the taxable year. It is the cash method taxpayer who is subject to great uncertainty. The IRS position, expressed in Rev. Rul. 70-609, is that income taxes affect earnings and profits of a cash method taxpayer in the year in which actually paid. (There was also a corresponding ruling dealing with excess profits taxes, I.T. 3719 (1945).)

Under Rev. Rul. 57-332, it seems clear that, for the accrual basis taxpayer, the decrease in earnings and profits by reason of a fraud penalty occurs in the year when the return is filed (following Stein (1956)).

Apparently taxes other than federal income taxes would be taken into account in accordance with the rule determining their deductibility for federal income tax purposes. In the case of disputed taxes, this determination would include application of the Dixie Pine Products (1944), doctrine, under which accrual method taxpayers may not deduct a disputed tax until the dispute is resolved. Also to be taken into account is sec. 461(f), which allows a deduction for contested taxes which are either paid or provided for.

Foreign taxes create still another problem, for they may be used either as a credit or as a deduction. If a credit is claimed, uncertainty with respect to earnings and profits is generated by the general rule that the credit is available in the year to which the tax relates. On the other hand, if a deduction is claimed, the cash and accrual methods presumably apply, including the Dixie Pine Products principle.
Commentary

The present state of affairs should be clarified. Fortunately, a large part of the problem has disappeared with the increasing requirement for all corporations to pay estimated taxes throughout the year. Of course, problems still exist with respect to taxes which are disputed and those which, notwithstanding the payment of estimated taxes, payover until the following year.

On the cash method issue, the IRS approach appears to be preferable, and, while there may possibly be elements of "fairness" in the approach typified by Demmon, the IRS logic seems to be superior. Furthermore, any inequity which exists is simply part of a larger picture in which the cash method taxpayer may omit from earnings and profits large amounts of uncollected accounts receivable. Furthermore, there is generally nothing to compel a taxpayer to use the cash method.

Recommendation

It is our recommendation that, in determining earnings and profits, taxes be taken into account in accordance with the rules that govern when earnings and profits may enter into the determination of taxable income for federal income tax purposes. Federal income taxes, for example, would be taken into account when paid by a cash method corporation or incurred (with reference to Dixie Pine Products doctrine and the principles of sec. 461(f)) by an accrual method corporation. Such a conclusion would also strike a blow in
favor of greater simplification by trying to maintain the relationship between methods of tax accounting and earnings and profits.
CHAPTER 9: EARNINGS AND PROFITS AND STOCK OPTIONS

The problem in this area is what effect, if any, the "bargain element" on the exercise of stock options should have on earnings and profits. Also, if there should be a decrease, should it be measured at the time when the option is issued or when it is exercised?

The statutory law does not solve this problem, which has been litigated in the courts. The appellate courts have found in reversals of other court decisions, that the spread between market price at the time of exercise and option price reduces earnings and profits.

Current Status of the Law

Code and Regulations

Although there is no specific statute dealing with the effect on earnings and profits of the exercise of statutory stock options, sec. 421(a) states certain relevant law:

If a share of stock is transferred to an individual in a transfer in respect of which the requirements of sec. 422(a), 423(a), or 424(a) are met--

(1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;
(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

Paragraph (a)(3) has been the subject of spirited debate as to whether an inference can be drawn therefrom regarding a change to earnings and profits.

**Leading Cases**

There are two leading cases in this area—**Luckman** (1968), and **Divine** (1972). Both cases involved the question of whether earnings and profits of Rapid American Corporation were reduced in the amount of the excess of the fair market value of its stock acquired by exercise of restricted stock options (predecessor of qualified stock options) over the option price. In both cases, the holding of the Tax Court that there was no reduction was reversed in the appellate courts.

The treatment of restricted stock options is covered in sec. 421. It provides that exercise of the option does not result in income to the exerciser or in a deduction to the issuing corporation and, in sec. 421(a)(3), cited above, that no amount other than the price paid under the option will be considered as received by any of such corporations for the transferred share.
The Tax Court in *Luckman* observed:

Even where such actual expenses or losses of a corporation are not recognized for income tax purposes, it is well settled that, in the absence of statutory language to the contrary, such items generally reduce earnings and profits.... However we find and hold that the statutory language and legislative history of 421 show that Congress did not intend for the exercise of restricted stock options to generate an expense, recognizable or otherwise. Thus, earnings and profits cannot be reduced.

The reasoning of the Tax Court was based on its reading of sec. 421(a)(3) and Senate Report No. 2375 (1950), issued prior to passage of sec. 130A (the predecessor to sec. 421).

Since sec. 421(a)(3) limits the amount deemed received by the corporation for an option, a question arises: What is the law excluding from deemed receipts? The Tax Court finds the answer in the Senate Report, which states that under the rules before enactment of statutory stock option law, an employee was taxed on the bargain element on an exercise of a stock option; that is, the corporation received services from the employee and gave him stock of equal value in compensation. But statutory options are incentive devices rather than compensation, and no deduction is allowed to the corporation upon their exercise. Sec. 421(a)(3) therefore means that the value of the services is not deemed received. "It follows that if no amount is considered received, there is no amount which can be considered as an item of expense to reduce earnings and profits."

The Seventh Circuit, in reversing, held that the bargain element in statutory stock options represents an economic expense.
to the corporation. The options have a business purpose—to reward employees. Therefore, they are not comparable to non-taxable stock dividends (which do not reduce earnings and profits).

There is nothing in the law which prohibits expense treatment (for earnings and profits purposes) of restricted stock options. (Compare sec. 312(f)(1), which prohibits such treatment for wash sales losses.) Sec. 421(a)(3) does not have the purpose of prohibiting such treatments. Its purpose is to limit taxable gain realized by a corporation which grants restricted options to employees in the stock of its parent or subsidiary. The Senate Report, cited by the Tax Court, is too meager to prove anything. The Court stated: "We feel that Congress would have made an express exception had it wished earnings and profits to remain unaffected by the exercise of restricted stock options under Section 421."

It stated further that the corporation "is entitled to treat [the bargain element when the options were exercised] as an expense, just as if they had paid this amount in cash to its employees."

The Tax Court in Divine declined to follow the Seventh Circuit's Luckman decision, contending, "If the corporation's earnings and profits were to be reduced at all it logically would be by only the value of the option when granted." However, there should be no reduction at all. Statutory options are incentive devices, not compensation, as witness the Senate Report. There is no reason to believe that the consequences to earnings and profits should differ from the consequences to taxable income.

In a second reversal of the Tax Court on this issue, the Second Circuit agreed with the Seventh Circuit that the bargain
spread is a compensation expense. The treatment accorded sec. 421 stock options should therefore not differ, then, from that accorded nonstatutory stock options, which do reduce earnings and profits, unless sec. 421 or legislative history indicated otherwise, which they do not. The court went on to observe that it was well settled that earnings and profits are not a carbon copy of taxable income and do not require consistent treatment.

Since the corporation has suffered economic detriment based on stock value when the option is exercised, the bargain spread at that time is deductible from earnings and profits.

The appellate decisions in Divine and Luckman were followed by the Tax Court in Anderson (1976).

In Anderson, the corporation acquired several subsidiary corporations and, as part of the acquisition, assumed the stock option obligations previously issued by the subsidiaries. Additionally, the parent corporation issued additional options to the same employees subsequent to the acquisition. All of the options were "qualified stock options" as defined in sec. 422. The court held that, based on Luckman and the intent of sec. 421, the difference between fair market value and the option price at date of exercise reduced the earnings and profits of the employer (the subsidiary) instead of the issuing corporation (the parent company).

Commentary

Maryland Law Review (1973). Dealing in general with the theory of earnings and profits, this article discusses the Luckman
and Divine cases in the Tax Court circuit. In defining earnings and profits, the article notes, the courts have focused on the corporation's potential for distributing realized gains to its shareholders. Therefore, for example, when a corporation distributes appreciated property as a dividend, it charges earnings and profits with basis, since only basis has been realized by the corporation.

There are exceptions, such as taxable stock dividends, which reduce earnings and profits by market value instead of basis. The author indicates that this exception is theoretically as indefensible as the Tax Court's analysis of the stock option problem is incomplete. Rather than be blindly guided by income tax treatment, the author suggests, the line of analysis must look to the real effect of the transaction on the corporate assets.

The article notes that stock options present problems for income tax treatment and for earnings and profits treatment. For income tax analysis, the problem is whether they are compensatory or a contribution to capital. In sec. 130A (1939 Code), Congress decided that statutory options would be treated as capital transactions and nonstatutory options would continue to be treated as taxable compensation when in fact, all option plans have a compensatory element.

The circuit court in Luckman understood this. It therefore reduced earnings and profits. Also, in light of LoBue (1958), it measured the compensation on the date of exercise. However, the author points out, the court erred in not carrying its analysis far
enough. The exercise of a stock option creates the appearance of a loss to the corporation, but the focus should be on the income tax base of the assets lost. Earnings and profits should not be reduced unless the corporation realizes a loss of assets.

It is also suggested that it is theoretically unsound to argue that granting a statutory stock option is the net equivalent of paying the employee in cash and allowing him to purchase the stock. In such form, it would not be a statutory stock option. Also, it is improbable that a corporation would commit itself to pay a cash sum dependent upon unrelated external market factors. More important, a cash outlay is a realized loss; with a stock option, there is no realized loss. Furthermore, the author concludes, the reduction of earnings and profits by the spread at exercise blurs the separate entity theory. The loss by dilution of equity is incurred by the shareholders, not by the corporation.

_McDaniel (1974)._ This article also discusses Luckman and Divine. The author, Paul R. McDaniel, maintains that earnings and profits should be reduced by the corporation's basis in the stock issued, thus agreeing with the conclusion of the Tax Court.

_Jacoby (1971)._ In this article, Richard A. Jacoby discusses Luckman, making many comments which were repeated in later articles. Although the author refers to the Tax Court's decision as "rather tenuous," he disagrees with the Seventh Circuit's reversal.
Recommendations

It is recommended that the appellate approach be followed. The change can be made by amendment to sec. 312 to provide specifically that difference between fair market value and exercise price will be taken into account in computing earnings and profits.
The law concerning the treatment of distribution of proceeds of government-insured loans is found in sec. 312(i), which states, in effect, that a distribution made by a corporation with respect to its stock, when the corporation has outstanding a loan made, guaranteed, or insured by the United States, is treated as a dividend to the shareholders if the amount of the loan exceeds the adjusted basis of the property distributed. The amount of the dividend will be equal to the excess of the amount of the loan over the adjusted basis.

Sec. 312(i) was enacted by Congress to combat a specific windfall to which the IRS objected. The fact pattern was simple. A building corporation would receive government-insured financing on a project; the financing would be secured by the project itself. Through inflated estimates of the cost of the project or builder expertise in reducing the cost of the project, the proceeds of the government-insured loan would ultimately exceed the total cost of the project. Before the corporation had earned any income and received any earnings and profits, the corporation would distribute the excess financing proceeds to its shareholders.

The result of such a distribution before the enactment of sec. 312(i) was a return of capital to the extent of the capital contribution; any excess was treated as a capital gain. This
technique was called "mortgage-out."

In short, to combat this situation, Congress adopted sec. 312(i). Sec. 312(i) creates a fictional earnings and profits account to the extent that government-insured financing exceeds the adjusted basis of the property securing the loan. As a result, each dollar of excess loan proceeds distributed is treated as a dividend to the shareholders.

Current Status of the Law

Code and Regulations

Internal Revenue Code of 1954, sec. 312(i)

Distribution of Proceeds of Loan Insured by the United States

(1) In General--If a corporation distributes property with respect to its stock and, if, at the time of the distribution -

(a) there is outstanding a loan to such corporation which was made, guaranteed, or insured by the United States (or by any agency or instrumentality thereof), and

(b) the amount of such loan so outstanding exceeds the adjusted basis of the property constituting security for such loan, then the earnings and profits of the corporation shall be increased by the amount of such excess and (immediately after the distribution) shall be decreased by the amount of such excess. For purposes of subparagraph (b) of the preceding sentence, the adjusted basis of the property at the time of distribution shall be determined without regard to any adjustment under Section 1016(a)(2) (relating to adjustment for depreciation, etc.). For purposes of this paragraph, a commitment to make, guarantee, or insure a loan shall be treated as the making, guaranteeing, or insuring of a loan.
(2) Effective Date—Paragraph (1) shall apply only with respect to distributions made on or after June 22, 1954.

Income Tax Regulations, Sec. 1.312-12

Distributions of Proceeds of Loans Guaranteed by the United States

(1) The provisions of Section 312(i) are applicable with respect to a loan, any portion of which is guaranteed by an agency of the United States Government without regard to the percentage of such loan subject to such guarantee.

Regulation

The application of sec. 312(i) is illustrated by the following example from reg. sec. 1.312-12:

Example. Corporation A borrowed $1,000,000 for the purpose of construction of an apartment house, the cost and adjusted basis of which was $900,000. This loan was guaranteed by an agency of the United States Government. One year after such loan was made and after the completion of construction of the building (but before such corporation had received any income) it distributed $100,000 cash to its shareholders. The earnings and profits of the taxable year of such corporation are increased pursuant to Section 312(i) by $100,000 immediately prior to such distribution and are decreased by $100,000 immediately after such distribution. Such decrease, however, does not reduce the earnings and profits below zero. Two years later, it has no accumulated earnings and has earnings of the taxable year of $100,000. Before it has made any payments on the loan, it distributes $200,000 to its shareholders. The earnings and profits of the taxable year of the corporation ($100,000) are increased by $100,000, the excess of the amount of the guaranteed loan over the adjusted basis of the apartment house (calculated without adjustment for depreciation). The entire amount of each distribution is treated as a distribution out of earnings and profits and, accordingly, as a taxable dividend.
Leading Cases

Although no cases have arisen under sec. 312(i) since its enactment, two key cases which arose prior to the enactment of sec. 312(i) underscore the IRS argument that it was necessary that a law on the order of sec. 312(i) be enacted: Woodsam Associates, Inc. (1951), and George M. Gross (1955).

In the Woodsam case, the taxpayer argued that a tax should be imposed upon the occasion of placing a mortgage, where the amount of the mortgage exceeded the cost of the property and the mortgagor bore no personal liability for the mortgage. Counsel for the taxpayer contended that, if the mortgage profit were not then taxed, it might escape taxation for all time in the hands of both the corporation and its stockholders. The Commissioner, who wanted to tax the mortgage profit in a later year, argued that borrowing was not a proper incident of realization. The Commissioner's argument was accepted by the Second Circuit Court of Appeals.

Ironically, the Commissioner's victory in Woodsam led to his defeat in Gross and provided a textbook example of the kind of abuse sec. 312(i) was enacted to correct. In Gross, the taxpayer's corporation financed a garden apartment complex with the proceeds of government-insured loans. The proceeds of such loans exceeded the cost of the project, and the corporation distributed the excess. The Tax Court treated the distribution as an impairment of capital and accorded it capital gain treatment.
Sec. 312(i) has had the impact of halting litigation involving the distribution of proceeds of government-insured loans. Although the Gross case was decided in 1955, after the adoption of sec. 312(i), the case actually arose under the 1939 Code and thus before the adoption of sec. 312(i). The section has not been tested in the courts, and few commentators have considered the statute worthy of extensive comment.

Lurie (1955). In his article, "The Messrs. Gross and Morton: Modern '49er's," Alvin D. Lurie has raised the question of whether sec. 312(i) is constitutional. Lurie notes that sec. 312(i) taxes distributions derived from corporate borrowings as dividend income in the hands of the shareholders. Unless the corporation has current or accumulated earnings and profits, he contends, it is really incapable of distributing to its shareholders anything that is in the nature of income. Any distribution of government loan proceeds before there are any earnings and profits should be a return of capital; yet, under sec. 312(i), the first dollar of distribution is taxed even before the basis for the stock has been recovered.

Lurie's contention that sec. 312(i) is unconstitutional is based on the fact that the statute creates constructive earnings where, in fact, there have been no earnings realized. Lurie notes that, under cases going back to Macomber (1920), the courts have recognized that the Sixteenth Amendment cannot be used
to sanction taxes on items which are not in fact income. He then argues that, if the tax is not a tax on income within the meaning of the Sixteenth Amendment, it then becomes a direct tax prohibited by Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4, and therefore, is unconstitutional.

Recommendations

No recommendations are made at this time.
CHAPTER 11: EARNINGS AND PROFITS AND THE
INVESTMENT TAX CREDIT

One question arises concerning earnings and profits and the investment tax credit: How should the investment tax credit affect earnings and profits?

Current Status of the Law

Revenue Rulings

Rev. Rul. 66-330, which appears to be a definitive statement with regard to this matter, makes the following provisions:

1. The investment credit is a reduction of federal income taxes in the year in which the credit is offset under circumstances where the credit is attributable to assets placed in service during that year or is attributable to a carryover;

2. If there is an investment credit carryback, the increase in earnings and profits occurs in the year in which the unused credit arises;

3. There is no adjustment to be made to earnings and profits other than the regular reduction caused by the depreciation deduction (subject, of course, to sec. 312(k)).
Questions had resulted in connection with an earlier ruling, Rev. Rul. 63-63, which did not come to grips with the affect on earnings and profits of the then-existing reduction of basis of depreciable property for the amount of investment credit pursuant to sec. 48(g). Fortunately for many purposes, including this one, sec. 48(g) was subsequently repealed. Rev. Rul. 66-336 makes clear that the temporary reduction of basis caused by the enaction of sec. 48(g) and the subsequent restoration of basis caused by its repeal have no effect upon earnings and profits.

Recommendation

It is recommended that the charge against earnings and profits should be net taxes, that is, taxes less utilized investment tax credit.
CHAPTER 12: EARNINGS AND PROFITS AND THE ACCUMULATED EARNINGS TAX

An accumulated earnings tax is imposed under sec. 531 on the accumulated taxable income for the year. The problem which arises is whether a corporation must have had an increase in accumulated earnings for the taxable year, as well as accumulated taxable income, for the tax to apply, since Part I of subchapter G of the Code uses such terms as corporations "improperly accumulating surplus" and being subject to the "accumulated earnings" tax.

Another current problem which is not considered germane to this discussion and which is therefore not further elaborated upon, relates to whether marketable securities should be taken into account at fair market value or tax basis in determining whether a corporation has improperly accumulated its earnings.

Current Status of the Law

Sec. 531 imposes on the accumulated taxable income (as defined in sec. 535) of every corporation described in sec. 532 an accumulated earnings tax equal to the sum of (1) 27 1/2 percent of the accumulated taxable income not in excess of $100,000, plus (2) 38 1/2 percent of the accumulated taxable income in excess of $100,000. Other relevant sections also refer to corporations
subject to accumulated earnings tax (sec. 532), and earnings and profits permitted to accumulate beyond the reasonable needs of the business. Sec. 535, in defining "accumulated taxable income," allows a credit for "accumulated earnings," which is defined in subsection (c) as an amount equal "to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business...."

Leading Cases

In GPD, Inc. (1973), the Commissioner assessed an accumulated earnings tax for the years 1967 and 1968. For 1968, earnings and profits were increased by $278,783 net income for the year and were decreased by $67,440 dividends paid. There was a further decrease of $432,640 in earnings and profits during 1968 as the result of the redemption of about 39 percent of the corporation's stock which had been donated to charities in prior years by the otherwise sole shareholder. The accumulated earnings and profits at the end of 1968, after the redemption, was $1,361,099.

The Commissioner argued that an increase in earnings and profits during the taxable year is not a requirement for imposition of the accumulated earnings tax. The tax is levied on "accumulated taxable income" and not on the increase in "earnings and profits."

The taxpayer maintained that, although the accumulated earnings tax is measured by a percentage of the "accumulated taxable income," the tax is imposed only on corporations formed or availed of for the purpose of avoiding the income tax with respect to their
shareholders by permitting earnings and profits to accumulate instead of being divided or distributed. Since there was a net decrease in accumulated earnings and profits in 1968, the tax should, therefore, not apply.

In prior cases, such as W. S. Farish & Co. (1938), Corporate Investment Co. (1939), and American Metal Products Corp. (1960), the court held that, where there was no increase in earnings and profits during the year, the accumulated earnings tax could not be imposed. The Commissioner argued that Farish was distinguishable because the corporation had a deficit, that the other two cases were incorrectly decided, and that the court should reconsider its holding, particularly in view of the tax avoidance which would otherwise result.

GPD's sole shareholder had already obtained charitable deductions for the fair market value of the donated stock. By properly timing the redemption, GPD was avoiding the accumulated earnings tax unless the court intervened.

The Tax Court, however, noted that a similar situation existed in Corporate Investment, where it had refused to apply the accumulated earnings tax. This tax could only apply where earnings were accumulated.

The Commissioner also cited Ostendorf-Morris Company (1970), an unreported decision in which the facts were similar to those in GPD. The court held that the accumulated earnings tax could be applied, although there was no increase in earnings and profits during the year. To hold otherwise (since sec. 532(a) does
not speak in terms of permitting a particular amount of earnings and profits to accumulate) would mean that the tax could be levied on a corporation which had a one-cent increase from current earnings, but not on a corporation which used all current earnings to redeem stock. This could also set the stage for tax avoidance by proper timing of the redemption.

The Tax Court refused to change its position enunciated in Corporate Investment and in American Metal Products, which cases had been outstanding for many years without substantive changes in the relevant law by Congress. Judge Tannenwald dissented, distinguishing each of the cases relied on by the majority. In Farish, the Board held that "although the transferor's cost was proper in computing taxable income, it was the book cost for the corporation that should be used in computing earnings and profits for the purposes of the tax on unreasonable accumulation of earnings. That case therefore is not controlling."

In Corporate Investment, the corporation had by an honest mistake underestimated earnings and profits. There was no improper motivation, and the case should not be controlling.

In American Metal Products, Tannenwald wrote,

The issue of earnings and profits versus taxable income was not raised or argued by the parties. It was raised by this Court on its own motion and disposed of without analysis and simply in reliance on Farish and Corporation Investment Co. Sec. 34 TC at 104. The issue was not appealed by the respondent, so the affirmance by the Eighth Circuit is of no significance.
He continued:

I see no difficulty in interpreting Section 532 so as to include earnings and profits of prior years within the statutory clause by permitting earnings and profits to accumulate instead of being divided or distributed. A past situation can be permitted to become a current situation.

On appeal, GPD, Inc. was reversed by the Sixth Circuit Court of Appeals (1974). The court held that "taxable income" and "earnings and profits" were separate and distinct statutory terms. The former was for the purpose of determining a tax, while the latter was for the purpose of determining whether corporate distributions were taxable as dividends and was a much broader concept than "taxable income."

The court went on to trace the legislative history of the accumulated earnings tax and the terminology used. The tax was first imposed on the shareholders with respect to gains and profits permitted to be accumulated by the corporation, treating the corporation for the purpose as if it were a partnership. Under this concept, Congress would not have intended the tax to be applied solely to corporations having current gains and profits. Considering the 1934 Act and previous acts, the court reasoned that Congress did not intend non-pro rata distribution to be used as a means to avoid the tax.

The Revenue Act of 1954 continued to use the phrase "permitting earnings and profits to accumulate instead of being divided or distributed." The court stated that there was no intention by Congress to require an accumulation of earnings and profits in the
taxable year as a condition precedent to imposition of the accumulated earnings tax. To allow non-pro rata redemptions to reduce current earnings and profits would frustrate the purpose of the statute. It would also be inconsistent with the statute which disallows non-pro rata distributions as a deduction in computing accumulated taxable income subject to the tax.

The court concluded that, under sec. 531, sec. 532(a) does not require an accumulation of current earnings and profits. Also, since past accumulations of earnings and profits are relevant to the property of current accumulations, they cannot be irrelevant in determining whether the corporation was availed of for the prescribed purpose. The court agreed with Ostendorf-Morris Co. and Judge Tannenwald's dissenting opinion in GPD.

Commentary

**Sitrick-Edelstein Controversy (1965-1968).** A note in the Tax Law Review (1965) by James M. Sitrick was later criticized by Haskell Edelstein (1968), which in turn generated a rebuttal by Sitrick and a further dissent by Edelstein. Since these discussions contain many references to American Metal Products Corp. (1960), it would be well to set forth the pertinent portions of that case.

American Metal and a related corporation, Adler, were found by the court to be subject to the accumulated earnings tax for various years. However, Adler was not subject for 1953. As of December 31, 1952, Adler's surplus amounted to $658,399. For 1953,
it had net income after taxes of $36,542 and showed a Schedule M debit of $37,006, described as accumulated earnings tax. The surplus as of December 31, 1953, was $657,935. The Tax Court stated:

With respect to the year 1953, the balance sheet of Adler Corporation reveals that the total of its surplus and surplus reserves as of the end of the year 1953 ($657,934.74) was less than the total amount of its surplus and surplus reserves as of the end of the preceding year ($658,398.66) and, accordingly, that there was no accumulation of 'earnings or profits' by Adler Corporation during that year. This fact has not been called to our attention or discussed by either of the parties. It cannot, however, be ignored. As our findings indicate, this situation apparently resulted from the payment of an 'Additional Federal tax' which, though nondeductible in determining the 'section 102 net income' upon the basis of which the surtax would otherwise be computed (section 102 (d)(1)(A)), is nevertheless to be considered in determining whether the corporation was 'availed of for the purpose of preventing the imposition of the surtax upon its shareholders ... through the medium of permitting earnings or profits to accumulate instead of being divided or distributed.' As was stated in W. S. Farish & Co., 38 BTA 150, 158 affd. 104 F.2d 833, 'taxable net income is purely a statutory concept, and bears no necessary relation to gains and profits subject to distribution as dividends....' The proscribed act is the accumulation of 'gains and profits' and not 'net income' or 'taxable net income.' Each year is to be considered separately, W. S. Farish & Co., supra; Corporate Investment Co., 40 BTA 1156, 1171. Under the circumstances presented herein, section 102 is not applicable to the Adler Corporation for the year 1953.

In his 1965 note, under the basic premise that the accumulated taxable income subject to the sec. 531 tax cannot exceed the increase in earnings and profits accumulated for the taxable
years, which is confirmed by American Metal Products, Sitrick proceeds to argue that the present law is unworkable and unrealistic. His argument is based on the now well-settled right of a taxpayer to accrue income tax deficiencies, whether or not contested, in computing its earnings and profits. Using the American Metal limitation rule, he then shows, by way of example, how three "circular" adjustments, caused by interrelationship of the earnings and profits, for the year and a sec. 531 tax, ultimately are reduced to zero. He therefore differs with the case with respect to which year's earnings and profits should be reduced for the sec. 531 tax assessment paid in the taxable year for a prior year. Sitrick concludes that the general rule for accrual of contested taxes must therefore be abandoned and reduction of earnings and profits for a sec. 531 tax should only be made in the year in which the tax is asserted.

Edelstein countered that Sitrick's premise was wrong since the sec. 531 tax is imposed on the accumulated taxable income and no deduction is allowed for the sec. 531 tax in arriving at the accumulated taxable income. However, he then states that the concept of earnings and profits does enter the picture in making the preliminary determination whether the corporation is subject to tax pursuant to sec. 532(a) "by permitting earnings and profits to accumulate." If no earnings and profits accumulate during the year, the tax cannot be imposed on accumulated taxable income. This is all that American Metal says.
Edelstein agrees with Sitrick's proposition that the accumulated earnings tax should be charged to earnings and profits in the year in which asserted, but for a different reason. For Edelstein the tax is a penalty tax which is not automatically computable and payable once taxable income has been determined.

Thus, although they differ regarding the base on which the tax should be computed when the accumulated taxable income is in excess of the increase in earnings and profits for the taxable year, both agreed that there can be no tax unless there is an increase in the earnings and profits accumulated for the taxable year.

Sitrick's reply argues that if Edelstein's logic is followed, a corporation which has accumulated taxable income for the year will be taxed on the full amount if it has $1 of accumulated earnings and profits for the year; but will not be taxed at all (under sec. 531) if that $1 is eliminated.

The controversy concludes with a final reply by Edelstein. As to Sitrick's argument that an accumulation of $1 in earning and profit during the year could subject a corporation to sec. 531 on a very large accumulated taxed income—as a practical matter, it is doubtful this would happen. However, if it should happen, Edelstein labels the situation as "a problem which I believe requires statutory correction."

Edelstein also rewords and amplifies his previous statement with respect to the year of accrual of sec. 531 tax liability. As a general rule, it should be deducted in computing earnings and
profits only when such penalties become final as to both the amount and the fact of liability.

Bittker and Eustice (1971). Bittker and Eustice refer to this debate and comment: "Sitrick ... argues that current earnings and profits are a ceiling on computation of the Section 531 tax, a conclusion that seems unsupportable from the language of Section 535."

Recommendation

It is recommended that the computation of sec. 531 tax liability be based on accumulated taxable income for the year, but the amount of accumulated taxable income should not exceed the accumulated earnings and profits at the end of the taxable year. Any accumulated earnings tax liability for the year would not reduce the base on which the tax was imposed. Sec. 531 tax liability would reduce earnings and profits in the year in which an agreement was reached with respect to the liability.
CHAPTER 13: EARNINGS AND PROFITS IN CONSOLIDATED RETURNS

The Consolidated Regulations Tier-Member Adjustments

The authority regarding adjustments to be made to earnings and profits to reflect investment adjustments is found in reg. sec. 1.1502-32(d) and -33. These paragraphs state that, in the absence of an election by the consolidated group to increase or decrease earnings and profits currently to reflect investment adjustments, the adjustments to earnings and profits will be deferred to a later year. However, where there are more than two tiers of ownership in a group, the deferred adjustment for a lower-tier member made by an intervening member would result in a duplication of the tier adjustment if the higher-tier member were to use the intervening tier member's earnings and profits for the later year to measure its investment adjustment.

For example, assume that in a consolidated group consisting of A, B, and C, A owns all of B's stock, and B owns all of C's stock. If B has a basis of $50 for its stock in C, and C generates $100 of earnings and profits, B's basis in C's stock is increased to $150. Further, even though B does not reflect the $100 adjustment in its own earnings and profits, it will in effect be treated as if it had done so for purposes of having A increase
its basis for B stock under the tier adjustment rule. If in the following year, B sells its C stock for $150, assuming no further earnings or losses by C, B will increase its earnings and profits by $100 due to the disposition because gain or loss is measured for such purposes without regard to investment adjustments pursuant to reg. sec. 1.1502-33(c)(4)(i)(b). If A were to use the earnings and profits of B for the second year as a measure of its adjustment, the $100 would be duplicated.

The provisions of reg. sec. 1.1502-32(d)(1)(i) operate to eliminate this duplication by adjustments to earnings and profits in the later year, but only for the purpose of using such earnings and profits as a measure of a higher-tier member's investment adjustment for the later year.

Thus, A will treat B as having no increase in earnings and profits on account of the disposition of C by B for purposes of adjusting its basis for B stock, in order to avoid duplicating the prior year's tier adjustment.

The effect is thus one of adjusting earnings and profits currently for the purpose of using earnings and profits as a measure of investment adjustments. Similar rules apply to prevent duplication of a lower-tier member's investment adjustments or an earnings and profits disappearance where there were tier adjustments in years preceding a switch to current adjustment of earnings and profits, and the lower-tier member's earnings and profits (or deficit) that gave rise to the tier adjustment is reflected in the earnings and profits of an intervening tier member after the group has switched to current earnings and profits adjustments.
Current Status of the Law

Code and Regulations

The text of Income Tax Regulations reg. sec. 1.1502-32(d) (1)(i) and -33(c)(4)(i-iii) is contained in Appendix 6.

Commentary

The tier adjustments correct a situation under the pre-1966 regulations in which it was possible for the group to avail itself of the losses of a third-tier subsidiary and then sell the stock of the subsidiary without being required to make any compensating adjustment in the basis of the stock of the second-tier subsidiary.

Inasmuch as current adjustments of earnings and profits will be required for taxable years beginning after 1975, the problems caused by the interplay between these sections will be diminished in the near future, although pre-switch versus post-switch adjustments will probably be required for some time.

Recommendations

Adjusting earnings and profits currently will have the effect of eliminating deferrals and treating the earnings and profits adjustment consistently with the investment adjustments. As noted previously, this adjustment will be required for taxable years beginning after 1975, pursuant to reg. sec. 1.1502-33(c)(4)(ii). Therefore, no recommendation is made at this time.
Contracts Under Which the Parent Covers the Subsidiary's Losses

Earnings and profits are generally thought to reflect only realized fluctuations in asset values. When a realizable event occurs which will have an effect upon earnings and profits, however, a question arises: Does a covering of a subsidiary's losses by the parent under contract reduce the parent's earnings and profits? In the instance where a parent has contracted with a subsidiary to reimburse the subsidiary for losses which it has incurred, two results may occur:

1. If the payment is treated as a reduction of the parent's earnings and profits, subsequent distributions to its shareholders by the parent may be partially non-taxable and be treated as a return of capital.

2. If the payment is treated as a contribution to the capital of the subsidiary, there will be no reduction in the earnings and profits of the parent, and thus there will be no benefit realized by the shareholders of the parent upon a distribution by reason of that loss.

Current Status of the Law

Code and Regulations

In the absence of any affirmative action on the part of the parent, there are no specific statutory or regulatory provisions dealing with the contemplated situation, which is based upon
the fact pattern of a case which arose in 1959. This situation could presently be remedied by the election under reg. sec. 1.1502-33(c)(4)(iii), applicable to years beginning after December 31, 1965 (and required of all taxpayers after December 31, 1975), to adjust earnings and profits currently in conjunction with the investment adjustment.

Leading Cases

The instant fact pattern is based upon the case of Freedman (1958). In that case, the taxpayer, a shareholder of the parent corporation, received a distribution but reported only a portion as a dividend. He contended that the remainder was paid after the corporation's earnings and profits had been exhausted, on the theory that earlier payments made to its subsidiaries under a contract to cover their losses were chargeable to earnings and profits. The parent and the subsidiaries had filed consolidated returns for the taxable years during which the payments were made. The IRS rejected the taxpayer's claim and assessed a deficiency, upheld by the court, which stated that the payments were mere contributions to the subsidiary's capital.

Commentary

Stanford Law Review (1959). In this article the author takes issue with the court's decision in Freedman. The decision rested on the ground that the subsidiaries were separate juridical entities, and thus there could be no realization to the parent when
the losses were incurred. The article points out, however, that, while the Code's structure apparently requires the separation of legal entities for purposes of determining their taxable income, the same construction does not necessarily follow for earnings and profits. Since earnings and profits are measured for the purpose of determining taxability to the shareholders, he contends that such measurement should be unaffected by the various policy considerations involved in the computation of taxable income.

In addition, the author places much weight on the fact that consolidated returns have been filed, and argues that legislative history, the consolidated excess profits tax and accumulated earnings tax regulations, and the basis adjustment provisions all mitigate in favor of consolidating earnings and profits.

Recommendations

For taxable years beginning after December 31, 1975, the current earnings and profits adjustment will be required by the provisions of reg. sec. 1.1502-33(c)(4)(ii). Therefore, no recommendation is made at this time.

Allocation of Tax Liability Among the Members of an Affiliated Group

The law regarding adjustments to be made to earnings and profits as a result of the allocation of consolidated tax liability is set forth in sec. 1552 and in reg. sec. 1.1502-33(d). Under
sec. 1552, the group may choose from four methods of allocating actual tax liability, while, under the regulations (which can be utilized only if the group elects to adjust earnings and profits currently), three additional methods are provided by which tax benefits can be allocated as well.

These rules of allocation have particular significance not only with respect to the annual investment adjustment, but also in the determination of the earnings and profits of the members of the group. This two-fold significance may be explained by the fact that the actual liability payable by a member may differ from that allocated under the elected method, in which case "deemed" distributions or "deemed" capital contributions may be considered to have taken place. For example, if a subsidiary pays an amount to the parent in excess of amount allocable, the excess is treated as a distribution by the subsidiary to the parent, decreasing the earnings and profits of the subsidiary and increasing the earnings and profits of the parent.

If, on the other hand, the subsidiary pays an amount to the parent that is less than amount allocable, the difference is treated as a contribution to the capital of the subsidiary by the parent.

The situation can become somewhat more complicated, with latent earnings and profits effects, where payments are due between various subsidiaries. For example, subsidiary A has a liability to subsidiary B under the elected allocation method because some tax attribute of B inured to A in consolidation.

Should subsidiary A not make payment to subsidiary B,
the effect will be one of a dividend by subsidiary B to the parent (reducing B's earnings and profits and increasing the earnings and profits of the parent), followed by a contribution by the parent to the capital of subsidiary A. This capital contribution is not part of the annual investment adjustment and thus would not be subject to reversal if a piecemeal disposition of subsidiary A were to be made.

It should also be noted that the implications of the dividend and capital contribution situation can appear at each tier in a multiple-tier affiliated group, rendering the problem even more complex with respect to possible unintended results.

Current Status of the Law

Code and Regulations

Sec. 1552 permits an affiliated group to elect one of several methods of allocating the consolidated tax liability among the members for purposes of determining the earnings and profits of each member.

The methods prescribed in sec. 1552 are:

1. The consolidated tax liability is apportioned to each member in the ratio that the portion of the consolidated taxable income attributable to such member bears to the consolidated taxable income.

2. The consolidated tax liability is apportioned to each member in the ratio that the tax of such member computed on a separate-return basis bears to the total
amount of taxes for all members computed on a separate-
return basis.

3. The consolidated tax liability excluding any
tax increases resulting from consolidation is allocated
as in (1) above, and any increase in tax resulting from
the consolidation is allocated in proportion to the
reduction in tax liability of each member as a result of
filing a consolidated return.

4. The tax liability of the group may be allocated
in accordance with any other method selected by the
group with the approval of the Commissioner.

Reg. sec. 1.1502-33(d)(2), regarding consolidated returns,
allows additional methods of allocating consolidated tax liability
for years beginning after December 31, 1965, in order to allow the
group to allocate tax benefits among the members. Allocations of
tax under these methods are treated for earnings and profits pur-
poses as if they were allocations of tax liability, even though the
amounts allocated may exceed the consolidated tax liability.

There are three methods prescribed in reg. sec. 1.1502-33(d):

1. The consolidated tax liability is first
allocated in accordance with one of the three methods
enumerated in sec. 1552. However, the amount of tax
liability allocated is limited to the excess of the
separate return tax liability of the member (computed
as if separate returns were filed for all taxable years,
including the current year, in which the member was
covered by the election), over the total tax liability
allocated to the member in previous years covered by
the election. Any excess tax liability is then
reallocated among the members who benefited from the filing of consolidated returns using the same formula except that the amount of tax liability allocated in the first step is added to the total tax liability allocated in previous years. The amounts reallocated are limited in total to the amount of tax reductions realized from filing on a consolidated basis.

If there is any tax liability remaining after the second allocation, it is allocated in accordance with the elected sec. 1552 method. This method may involve as many as three separate allocations before the total allocated tax is determined.

2. The consolidated tax liability is first allocated in accordance with one of the three methods enumerated in sec. 1552. An additional amount is then allocated to each member to the extent that the separate return basis tax liability exceeds the amount which was allocated to the member under the elected sec. 1552 method. This additional amount, however, may be only partially allocated depending upon the choice of the group members. A fixed percentage (specified by the members and included in the first consolidated return for which the allocation method is effective) of the additional amount up to 100 percent may be selected by the members to be allocated.

3. The consolidated tax liability and benefits may be allocated under any other alternative method approved by the Commissioner.

Commentary

Tiedemann (1973). In his article, William J. Tiedemann suggests that the purpose of permitting the election of a method of allocating tax benefits is to reduce or eliminate any differences which might exist between the tax allocation method in effect under sec. 1552 and that called for in the tax-sharing agreement among the members of the affiliated group.
He notes, however, that it may be extremely difficult, if not impossible, to achieve the desired uniformity since the consolidated group will almost invariably have certain modifications or unique arrangements in its tax-sharing agreement due to the particular nature of that group which cannot be reconciled with one of the enumerated methods of allocation called for in the regulations. The author calls upon the IRS to respond to this particular problem (while furthering its own apparent objective of achieving uniformity of allocation methods) by approving methods of tax liability allocation other than those which are specifically enumerated in the Code and regulations.

It should be noted that, while the Commissioner has been granted the express authority to make such approvals (sec. 1552(a)(4) and reg. sec. 1.1502-33(d)(2)(iii)), approvals have been granted only sparingly, generally in cases where there has been only slight divergence from the enumerated methods of allocation.

Recommendations

It is recommended that the IRS establish more definitive guidelines for approval of alternative methods of tax allocation other than those specifically enumerated in the Code or regulations. To date, only Rev. Rul. 57-392 has described another approved method of allocation, and that ruling approved a slight variation from the first alternative under sec. 1552.

A suggested approach to the resolution of this problem could consist of allowing as an "approved" alternative method the
method of allocation adopted by the group in its tax-sharing agreement, subject to the right of the Commissioner to revoke retroactively the allocation method if it is shown to be unreasonable or does not reflect the reality of the facts and circumstances.

Guidelines promulgated either by revenue ruling or regulation would greatly assist corporations in adopting that tax allocation method which most closely conforms to the tax-sharing agreement in effect among the members of the group.
Earnings and profits of a foreign corporation must be determined in a number of situations that have implications for U.S. tax purposes. These situations include dividend payments, redemptions of stock reorganization and liquidations, computation of foreign tax credits, foreign personal holding companies, controlled foreign corporations (CFCs) having subpart F income, investment in U.S. property, and sale of stock of a CFC subject to the rules of sec. 1248. Unfortunately, there is no one prescribed method for determining such earnings.

Reg. sec. 1.902-3(c)(5) provides two different ways to compute earnings and profits of a CFC for purposes of computing the foreign tax credit. If the minimum distribution rules of sec. 963 do not apply, an election may be made to make the determination under reg. sec. 1.964-1, except for paragraphs (d) and (e), which provide respectively for translation into U.S. dollars and recognition of unrealized foreign exchange gain or loss.

If no election is made, the earnings and profits are to be determined without regard to the elections permitted under the sec. 964 regulations. In such case, Rev. Rul. 63-6 (and cases cited therein) provides that U.S. tax principles are to be used, and the earnings and profits would be determined under reg. sec.
If the minimum distribution rules of sec. 963 apply (after 1975, these rules are repealed), or if an election is made under sec. 902, the rules of reg. sec. 1.964-1 for computing earnings and profits must be used.

Thus, depending on whether an election is made or whether or not a corporation is a CFC, different rules may apply in computing earnings and profits. Also, to complicate the situation further, it is not clear whether, even if an election is made to use the rules of sec. 964 and the regulations issued thereunder, the election is still valid if a corporation ceases to be a CFC. Thus, different computations may be required for different years, which can create a complicated situation.

Further compounding the situation is the fact that even where elections are made under sec. 964, if the minimum distribution rules of sec. 963 do not apply, a corporation is precluded from making the specific elections provided under paragraphs (d) and (e). The same inconsistencies arise in computing earnings and profits of a foreign branch and of a foreign subsidiary not under the rules of sec. 964.

Still another problem may arise concerning the different foreign exchange conversion rules used in determining earnings and profits in connection with computation of the foreign tax credits.

If the sec. 964 rules do not apply, the exchange rate used is that on the date the dividend was paid by the foreign corporation. Where sec. 964 applies, the regulations issued
thereunder contain different exchange conversion rules. Here, again, computations of earnings and profits (and foreign tax credits) will differ, depending on whether the foreign tax credit has been computed under the rules of sec. 964.

The application of elections allowed under the sec. 964 regulations gives rise to yet one more problem. The most pressing question at the present time would be whether a LIFO election under sec. 472 could be made in computing the earnings and profits of a CFC where LIFO accounting is not permitted or used for foreign accounting purposes but will be used in the U.S. company's consolidated financial statements. A final problem area is the determination of historical costs under the depreciation election.

Current Status of the Law

Code and Regulations

Specific rules for determining earnings and profits of a CFC are set forth in sec. 964(a) and reg. sec. 1.964-1. Sec. 964(b) and reg. sec. 1.964-2 provide rules for exclusion of blocked foreign income from earnings and profits of a CFC.

Reg. sec. 1.902-3(c)(5) provides alternative rules for determining earnings and profits in connection with the foreign tax credit. A CFC making a minimum distribution under sec. 963 having subpart F income, or otherwise coming within secs. 951-964, must use these rules. All other CFCs may elect to use these rules but cannot use the elections under paragraphs (d) and (e) of reg. sec. 1.964-1. If the rules of sec. 964 do not apply, Rev. Rul.
63-6 provides that the earnings and profits (accumulated profits) are determined pursuant to criteria applied under U.S. income tax law.

Under the rules of reg. sec. 1.964-1(a), which apply to years after 1962, earnings and profits are adjusted to conform to tax and accounting practices by the following steps:

1. Preparation of a profit and loss statement from books and records;
2. Adjustment to conform to U.S. accounting principles (if material);
3. Adjustment to conform to U.S. tax accounting standards (if material);
4. Translation in U.S. dollars at the appropriate exchange rate; and
5. Computation and adjustment for unrealized gain or loss.

These computations are generally referred to as the balance sheet or net worth method.

Leading Cases

Bon Ami Co. received a dividend in 1933, which was paid from the accumulated earnings of its foreign subsidiary for the years 1926 to 1932. The court ruled that the exchange rate to be used in computation of the foreign tax credit should be computed by translating the payment of Canadian taxes into U.S. dollars at the rate of exchange at the date of dividend declaration and not on the date of payment of the tax. The significance of the Bon Ami
(1939) decision with respect to earnings and profits is that this conversion rate has been carried over for use in translating earnings as well.

American Metal Company (1953 aff'd 1955), is similar to Bon Ami, but in this case, the foreign subsidiary kept its books so that the payments, earnings, and dividends were reflected in U.S. currency. As a result, there was no foreign exchange problem. The Tax Court therefore ruled that the exchange rate at the date of the dividend had no relation to the amount of foreign tax paid, to the accumulated earnings, or the dividend paid. Accordingly, the foreign tax credit, as well as earnings and dividends, were computed based on rates of exchange prevailing at the time of the transactions.

Revenue Rulings

Under Rev. Rul. 63-6, accumulated profits as determined under sec. 902 are equivalent to "earnings and profits," and the criteria applied under the U.S. income tax laws in determining earnings and profits are equally applicable to the determination of accumulated profits, since both denote the same source from which the dividends are paid. Both are to be determined according to U.S. income tax law.

Rev. Ruls. 75-105 and 75-106 illustrate computation of taxable profits and, indirectly, earnings and profits of foreign branches of a domestic corporation under the net worth or balance sheet method. Rev. Rul. 75-107 illustrates an acceptable computation under the profit and loss method.
Cook (1966). John W. Cook's article discusses the computation of earnings and profits of a CFC under reg. sec. 1.964-1. One of the elections (which refer to taxable years after 1962) relates to tax cost used for depreciation computations. "Undepreciated" cost on the first day of a 1950 taxable year can be used for assets acquired before 1950. On acquisitions of CFCs from 1950 to October 27, 1964, the assets can be treated as purchased at their fair market value at the date of purchase.

Cook points out that, although the term "undepreciated cost" is not clear and is not answered by the regulations, it would appear that it means "historical cost not reduced by depreciation." However, the informal position of Treasury apparently is that it means "book value." Also uncertain, the author states, is whether book value at January 1, 1950, must be readjusted to eliminate certain foreign accounting practices, such as a revaluation of assets, which is prohibited under sec. 964(a). Arguments, he concludes, can be made either way.

A related question treated in this article concerns the method of depreciation which should be used up to 1963. This question was resolved by TIR 752, which allows either (1) the method used on books if authorized under sec. 167; (2) the straight line method; or (3) the method adopted for first post-1962 year. The TIR also states that prior depreciation practices are not binding for post-1962 years. Thus, the author states, accelerated depreciation methods can be elected to reduce post-1962 earnings.
and profits. Under certain circumstances, however, including distributions by the CFC which have U.S. tax consequences, the Treasury may require the same method to be used for both periods.

Finally, the article points out some other unanswered questions under the sec. 964(a) regulations:

1. Will a CFC be permitted to use tax procedures permitted by foreign law which are analogous to U.S. tax provisions although not permitted under U.S. law? An example would be an initial write-off of fixed asset cost generally similar to the sec. 179 depreciation allowance.

2. What is the U.S. tax effect under sec. 964(a) of a revaluation permitted under foreign law but not under U.S. law? How does this affect depreciation and earnings?

3. Regarding the allocation of stock cost to assets, how will the IRS reconcile the conflicting regulations under secs. 334(b)(2) and 964(a)?

4. If a CFC uses LIFO for tax purposes but not for statement purposes, what will the effect be?

5. If the books reflect a reserve for bad debts at December 31, 1962, and the reserve method is elected for the first post-1962 year, is deductibility limited? Or, if the charge-off method is elected, may the reserve be recouped in the post-1962 year?

6. Where assets are revalued as a result of elections, is the offset to earnings and profits or to valuation reserves?
Lynch (1967). In his article, John A. Lynch comments on the inconsistency which exists, as prescribed by reg. sec. 1.902-3 (c)(5) in the determination of earnings and profits for foreign credit tax purposes, between rules in which sec. 963 applies and those in which it doesn't apply. Reg. sec. 1.902-3(c)(5)(i) doesn't allow utilization of unrealized exchange gains and losses in non-sec. 963 distributions and also requires a different method of translation. Although plural rules may be reasonable, Lynch contends, the requirement that such methods be applied in an inconsistent manner is unreasonable and contrary to tax and accounting rules of consistency. Assuming a situation in which there is devaluation of currency, the exclusion rules dilute historical depreciated charges. Tables are presented in the article to show differences in computation of foreign tax credits, dividends, and earnings and profits.

The author also notes the difference which has developed in determining earnings and profits of a branch (exchange gains or losses recognized) and a subsidiary not under sec. 963 (exchange gains and losses not recognized). A branch can use the net worth method while subsidiaries (other than CFCs eligible for the election under sec. 963) must use the profit and loss or "earnings" method, with translation of local currency into U.S. dollars at the same rate of exchange used to convert dividend distribution (the Bon Ami rule).
The author asserts that American Metal Company has negated the Bon Ami rule, which held that exchange rate at date of dividend had no relation to the amount of foreign tax paid to the accumulated earnings and dividends paid. However, he states, the American Metal case has had little impact in the area. Lynch further contends that secs. 901 and 902 also invalidated the Bon Ami rule (developed under predecessor sections). Thus, the amount and source of foreign tax paid must be determinable by reference to the source year, which has relation neither to dividend payment date, to the rate of exchange at that time, to whether the credit is to be determined under sec. 902 or 960, nor to whether the earnings are taxable under subpart F or relate to a branch or subsidiary.

He also points out that Rev. Rul. 63-6 simply holds that "accumulated profits" under sec. 902 are equivalent to "earnings and profits"; it does not give a method for translating earnings.

The author recommends that the balance sheet method, which is allowed on sec. 963 distributions in determining earnings and profits, dividend distributions, and foreign tax credits, be used for all distributions under sec. 902. He also advises contesting the exclusion rules.

Recommendations

It is recommended that there be adopted a uniform method of computing the earnings and profits of a CFC, without reference to whether the corporation has subpart F income. This method should follow the format prescribed by the regulations issued under sec.
However, the sec. 964 rules for computing earnings and profits should also be revised with respect to applicable foreign exchange rates to be used in determining earnings and profits to conform to the rules by the Financial Accounting Standards Board. This will also be the subject of a separate recommendation to be made by a AICPA federal tax division task force on the tax effects of currency fluctuations.

Having a uniform method of computing earnings and profits will also lead to uniformity in determining the amount of foreign dividends and the related foreign tax credits.

An alternative method, if prescribed, should be available only to non-CFCs. The repeal of the sec. 963 and the minimum distribution rules for years after 1975 certainly offer the opportunity to makes these changes. These changes do not require legislative action--they can be made by changing the applicable regulations.

In addition, the regulations should also expressly provide rules for a LIFO election by a CFC. That election should be available so long as the earnings of the CFC are reported on a LIFO basis in the consolidated financial statements of the U.S. parent company (and possibly, in the separate financial statements of the CFC submitted to U.S. stockholders, creditors, etc.).

Finally, clarification is also needed in determining historical cost at beginning of 1950 of depreciable assets. It should be made clear that such cost refers to undepreciated cost as shown on the books of the CFC.
CHAPTER 15: EFFECT OF BANKRUPTCY PROCEEDINGS ON EARNINGS AND PROFITS

Two principal questions regarding earnings and profits arise in the area of bankruptcy: their carryover and creation. The first question is whether earnings and profits will carry over following a bankruptcy reorganization. At the present time, a bankruptcy reorganization will serve to eliminate the earnings and profits or deficit account of the continuing or successor corporation involved in the reorganization, unless the reorganization is clearly encompassed by the provisions of sec. 381(a)(2) so as to allow the carryover pursuant to sec. 381(c)(2).

The present rule, in certain cases, may provide an inequitable result. If a corporation possessing earnings and profits is reorganized in bankruptcy and the former shareholders continue to hold their equity ownership, an additional boon is granted them. Later distributions made possible by the release of funds from creditor claims will be received tax free since such distributions will not constitute a dividend, the earnings and profits having been eliminated in the bankruptcy.

On the other hand, where a deficit exists and the creditors acquire the equity in exchange for their claims, the deficit (which reflects losses economically borne, at least in part, by the creditors) is eliminated and not available for offset against
any future earnings which may be distributed to the former creditors as a means of recovering their claims, thus rendering such dividends taxable.

Even in the instance where the bankruptcy reorganization was assumed to qualify as a tax-free transaction and sec. 381 would presumably operate to allow an earnings and profits carryover, such carryovers have been judicially disallowed \((\text{Dunning (1965)})\), based on a facts and circumstances test where it was found that the earnings and profits or deficit did not survive the bankruptcy proceeding and were extinguished therein.

An additional problem is posed where the reorganization qualifies under both secs. 371 and 368. It is unclear at the present time whether there is a legislative requirement of earnings and profits carryover pursuant to sec. 381(c) or whether the judicial treatment of extinguishment is applicable.

The second matter to consider is whether earnings and profits are created by the forgiveness of indebtedness. At the present time, Rev. Rul. 58-546, and Rev. Rul. 75-515, which held that earnings and profits were required to be adjusted by the forgiveness of debt, are in direct conflict with \text{Meyer (1967)}. The Meyer decision held that no earnings and profits were created by the forgiveness of debt in a bankruptcy proceeding. It is, therefore, unclear under the current law whether an adjustment to earnings and profits is required in a bankruptcy situation as a result of the forgiveness of indebtedness.
Current Status of the Law

Code and Regulations

Sec. 381(c)(2) provides for the carryover of earnings and profits in a tax-free reorganization encompassed by sec. 381(a)(2). Reg. sec. 1.381(c)(2)-1(a) provides for the carryover of deficits in reorganizations, but such deficits may only be used to offset future earnings. Except for the sec. 381(c) earnings and profits carryover rules applicable to tax-free reorganizations, the Code is silent as to the proper carryover treatment with respect to bankruptcy reorganizations. This void has been filled with a flood of confusing and sometimes conflicting case law which has left this area in a somewhat unresolved state.

Leading Cases

There has been considerable judicial action concerning the carryover of earnings and profits. In the case of F. R. Humpage (1952), a cash basis taxpayer sought reorganization under former sec. 77B of the Bankruptcy Act (the predecessor of Chapter XI), by a transfer of assets to a new corporation in which the former creditors of the old corporation held all the stock. Since the taxpayer was on the cash basis method of accounting, it had a positive earnings and profits account, although it was bankrupt because of a substantial amount of outstanding obligations.

The Tax Court held that the successor corporation did not carry over the earnings and profits of the bankrupt, relying on the bases of Cement Investors, Inc. (1942), and Alabama Asphalitic Limestone Co. (1942), by applying the "antecedent transaction" rationale.
At the inception of the proceedings, the creditors became the beneficial owners of the corporate assets (including the surplus, which was "inherent in" and part of the assets) and, because of that antecedent transaction, there were no longer any earnings in the hands of the debtor corporation which could be inherited by the successor.

In *Kavanagh* (1962), the Court of Appeals reversed the district court, which had held that the Sansome doctrine (requiring combination of parent and subsidiary earnings and profits and deficits) applied in light of the 1943 amendments to the Revenue Act equalizing treatment in voluntary and bankruptcy reorganizations. In reversing, the court held that Sansome was inapplicable since the former bondholders had received stock in satisfaction of their claims and the reorganized corporation began with a "new financial slate": so that past deficits could not offset future earnings.

Other cases extending and modifying these holdings have generally followed a view that the two-fold purpose of adopting the noncarryover rules is to avoid discouraging the use of bankruptcy by eliminating adverse tax consequences and to prevent manipulations in furtherance of tax-avoidance schemes. Fulfillment of those purposes has not, however, necessarily followed.

The *Meyer* case (1967), dealt with the question of whether earnings and profits were created or, more specifically, whether the deficit was reduced as a result of the cancellation of indebtedness under Chapter XI of the Bankruptcy Act to the extent the cancellation was in excess of the reduction of basis of the assets under the Act. The court held that no earnings and profits were created
by the forgiveness or cancellation of indebtedness arising from a
Chapter XI proceeding when the original shareholder's interests
continued. This issue remains unsettled, however, because the IRS
has announced in Rev. Rul. 75-515 that it will not follow the Meyer
decision.

Revenue Rulings

Rev. Rul 58-546, dealing with the treatment of accrued
expenses in a nonbankruptcy situation, required that earnings and
profits be increased for any forgiven debt arising from accrued
expenses which did not give rise to a tax benefit and were not
included in income under the revenue ruling.

The IRS used Rev. Rul. 75-515 specifically to announce
that it would not follow the Meyer decision which held that in an
arrangement under Chapter XI of the Bankruptcy Act the cancellation
of indebtedness exceeding the reduction of the basis of retained
assets does not reduce the deficit in earnings and profits. In
view of this second ruling, it appears that the matter of requiring
an adjustment to earnings and profits as a result of the forgiveness
of debt in a bankruptcy proceeding has not been clearly established.

Commentary

Testa (1963). Richard J. Testa's article proposes an
approach to the resolution of the seeming contradictions in this
area. His proposal consists of three parts:
1. The earnings and profits account of the bankrupt company are carried over (utilizing an expanded Sansome rationale but allowing deficit carry-over in light of (2) and (3) below).

2. Earnings and profits are increased by the amount of the debt discharged in bankruptcy (inasmuch as there is a carryforward of basis without reduction by reason of the discharge pursuant to sec. 372).

3. Earnings and profits are increased by the amount of the investment of security holders eliminated in the proceedings (analogizing to the repurchase of bonds at a discount or the tax treatment of stock redemptions).

The Testa proposals have been endorsed, with modifications, in the Report of the Commission on Bankruptcy Laws of the United States (1973).

Plumb (1974). As stated by William T. Plumb, Jr., in his article, the Commission would write into the law the Testa position that earnings and profits should be increased by the amount of debt reduction. Rather than rely upon judicial extension of the Sansome doctrine, sec. 381 would be extended to reorganization qualifying under sec. 371, and thus make applicable to bankruptcy situations the general earnings and profits inheritance rules.

The Commission, however, Plumb continues, would not increase earnings and profits for the discharge of debts for deductible items never deducted, a refinement of the Testa position.
to equate the treatment of cash basis and accrual basis taxpayers. In addition, he states, while the Commission agrees in principle with the Testa argument regarding eliminated investments, it does not extend this adjustment to positive earnings and profits and merely recommends that the deficit of a debtor or its successor be reduced by the amount of the capital account attributable to extinguished stockholder interests.

Recommendations

It is recommended that earnings and profits or deficits be carried over following a bankruptcy reorganization either by codification of a Sansome rationale or by the extension of the sec. 381 carryover rules to sec. 371, Chapter XI, reorganizations. In conjunction therewith, it should be provided that (1) earnings and profits be increased to the extent that a corporate liability is eliminated without stock being substituted for the claim and (2) earnings and profits be increased by the amount of the corporate investment of security holders whose interests are extinguished (recognizing that such shareholders will have enjoyed a deduction for the loss). Both provisions should be limited to reducing deficits to zero but not creating positive earnings and profits so as not to penalize former creditors who have become stockholders with prebankruptcy earnings out of which distributions would be deemed made.
"Sensitive payments," involving the use of company assets in practices that are illegal or highly improper in the eyes of governmental officials, the business and financial community, and, increasingly, the general public, may be nondeductible under U.S. tax laws. While these activities are not limited to international activities, they have been quite prevalent in international business.

When sensitive payments are made from a controlled foreign subsidiary of a domestic parent, it is necessary to consider their effect on the earnings of the foreign subsidiary in order to measure potential exposure to the domestic parent upon receipt of a dividend as direct inclusion under subpart F. Therefore, assuming earnings and profits determine the amount of subpart F income, the problem arises as to whether the transactions effecting the sensitive payments constitute proper reductions of earnings and profits and thereby reduce the amount of income reported in the United States through subpart F.

While there is little primary authority supporting the deduction of sensitive payments in computing the earnings and profits of the foreign subsidiary, secondary authorities have reviewed the purpose of the earnings and profits concept as an
attempt to quantify the economic resources of a corporation at a particular time. There is no question that sensitive payments, regardless of deductibility, reduce the economic resources of the foreign subsidiary and would affect the ability of the subsidiary to pay dividends.

Current Status of the Law

Code and Regulations

Sec. 951(a)(1) requires that a U.S. shareholder include in his gross income the sum of his pro rata share of the CFC's subpart F income for such year. Under sec. 951(a)(2), the pro rata share in the case of a U.S. shareholder is the amount

(A) which would have been distributed with respect to the stock which such shareholder owns ... in such corporation if ... it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

(B) the amount of distributions received by any other person during such year as a dividend with respect to such stock....

Sec. 952 defines subpart F income. Sec. 952(c) generally limits the subpart F income of the CFC for the taxable year to the earnings and profits of such corporation for such year. Reg. sec. 1.952-1(c)(1) says nothing further, but only limits the corporation's subpart F income to the shareholders' pro rata share of the earnings and profits of such corporation for such taxable year.

This language suggests that subpart F income should be
treated like a dividend—a constructive dividend from the foreign subsidiary—as opposed to a direct inclusion of taxable income.

Sec. 964(a), as amended, states:

Except as provided in Section 312(k)(3), for purposes of this subpart the earnings and profits of any foreign corporation, and the deficit in earnings and profits of any foreign corporation, for any taxable year shall be determined according to rules substantially similar to those applicable to domestic corporations.... In determining such earnings and profits ... the amount of any illegal bribe, kickback, or other payment (within the meaning of sec. 162 (c)) shall not be taken into account to decrease such earnings and profits....

This section thereby applies the law, judicial authority, and commentary relating to the computation of a domestic corporation's earnings and profits to foreign corporations.

Revenue Rulings and Procedures

That political contributions are apparently proper earnings and profits deductions is indicated in the work sheets appended to Rev. Proc. 75-17. In this revenue procedure the notation which specifies that political contributions are deductible in computing earnings and profits does not elaborate as to whether the political contribution was legal or illegal. However, the following opinions suggest that the legality of an expenditure should not affect its deductibility for earnings and profits purposes.

Other types of expenditures which arise in the sensitive payment area include reimbursements for unsupported travel and entertainment expenses, other unsupported expenses, and various other payment procedures which allow the employees and/or companies
to evade taxes or exchange restrictions. The law itself is silent in this area as it applies to earnings and profits of domestic and foreign corporations.

Although a fraudulent expense is not deductible for federal income tax purposes, the assessed fraud penalty is a reduction of earnings and profits. Rev. Rul 57-332, holds that

In determining the amount of corporate earnings and profits available for dividends... each fraud addition to a deficiency for which a corporation is held liable must be deducted from the earnings and profits of such corporation in the year that it filed the return to which the fraud addition applies, even though such penalty is contested.

This revenue ruling follows the holdings in Estate of Esther M. Stein (1956), and Stern Brothers & Company (1951). Also, Rev. Rul. 75-515, states:

In general, the computation of earnings and profits of a corporation for dividend purposes is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law. Thus, losses and expenses that are disallowed as a deduction for Federal income tax purposes, charitable contributions in excess of the limitations provided therefore, and other items that have actually depleted the assets of the corporation, even though not reflected in the income computation, are allowed as deductions in computing earnings and profits. For the same reason, accretions to the wealth of a corporation, such as nontaxable income and exempt income, increase the corporate earnings and profits that are available for payment of dividends to shareholders. See Section 1.312-6 of the regulations.

Rev. Rul. 77-442 followed the guidelines set forth in Rev. Rul. 57-332, Rev. Rul. 71-165, and Rev. Rul. 75-515 in
allowing payments described in Section 162(c) for the taxable year ending December 31, 1975, although not deductible in computing taxable income, to reduce earnings and profits. However, the ruling further stated:

... Thus, Section 162(c) payments made after November 3, 1976, will not reduce earnings and profits or increase the deficit in earnings and profits of a controlled foreign corporation for purposes of Subpart F.

Most commentators conclude that these types of payments are proper earnings and profits deductions, relying on the logic that as long as an expenditure reduces the economic resources of a corporation and is not a return of capital to the shareholders, its ability to pay dividends has been adversely affected. Thus, these expenditures should constitute proper deductions for earnings and profits purposes.

Commentary

Although the Code and regulations do not define "earnings and profits," basically, the concept of earnings and profits is one of economics. The purpose of the determination of earnings and profits is to measure the corporation's ability, at a given point in time, to make distributions which are more than a return of the shareholders' invested capital. Earnings and profits are, therefore, the net assets which have been accumulated in excess of paid-in capital.
Bittker and Eustice (1971). In their discussion of reduction of earnings and profits for nondeductible sensitive payments, Bittker and Eustice assert the following:

Earnings and profits should probably also be adjusted for certain other corporate outlays that are not deductible in computing taxable income, such as lobbying expenses and political contributions; there is little reason to think that Congress would have wanted such items to be disregarded in determining whether a distribution to stockholders came out of earnings or capital. More doubtful, however, is the proper treatment of expenses that are disallowed by new Sec. 162 (c), (f), and (g) (added by the Tax Reform Act of 1969) in computing taxable income on grounds of public policy, such as fines, bribes, overceiling price and wage payments, and the like, as well as contributions to organizations engaged in 'prohibited transactions' or subversive activities, see sec. 170 (i). Although these items might be classed with penalties for Federal income tax fraud, which have long been allowed by the Internal Revenue Service itself as deductions in computing earnings and profits, the 'frustrations of public policy' doctrine (newly codified in sec. 162) might be applied to a computation of earnings and profits, as well as to the computation of taxable income (7.03).

McDaniel (1974). In his article, Paul R. McDaniel discusses at some length the exclusion from earnings and profits of certain expenditures and expresses the following opinion:

Presumably the public policy limitation is now inapplicable in the deductions area except to the extent specified in Section 162(c), (e), (f), and (g) .... A similar question...is whether expenses now specifically disallowed as deductions...should likewise be disallowed as reductions in earnings and profits.

McDaniel concludes that the public policy arguments presumably do not apply as a limitation in earnings and profits computations.
Rudick (1941). In this article, Harry J. Rudick takes the position that unreasonable compensation, disallowed contributions, and certain expenses and interest, although not deductible in computing taxable income, "deplete the income available for distribution to stockholders and should be deducted in arriving at earnings or profits." Following this line of reasoning, the deductibility of an expenditure for earnings and profits purposes is determined on the basis of whether the expenditure depletes funds available for dividend payments. If an expenditure actually reduces funds, the author contends, it should likewise reduce earnings and profits.

B.N.A. Tax Portfolio No. 175 (1973). The Bureau of National Affairs' tax management portfolio on earnings and profits states the following:

For income tax purposes, certain items of business expense are not allowable as deductions, not because they are not true expenses of the corporation, but rather because Congress has concluded that to allow such deductions would not be good public policy. These items are:

- Section 162(b)—charitable contributions in excess of the limitations imposed by sec. 170
- Section 162(c)—illegal bribes, kickbacks, etc.
- Section 162(e)—lobbying expenses
- Section 162(f)—fines and penalties
- Section 162(g)—treble damages under the antitrust laws

For earnings and profits purposes, all of such disallowed items should be taken into account, since they represent real economic expenditures by the corporation.
Recommendations

The computation of earnings and profits is an attempt to measure the economic resources of a corporation at a particular time. As actual disbursements are made or losses incurred, they should be deducted from the earnings and profits account without regard to their deductibility under the income tax statute. Similarly, as amounts are received or economic benefits are realized, the earnings and profits account should be increased whether the full amount of such benefits is included in taxable income or not. The impact on a corporation's economic resources, whether the corporation is domestic or foreign, should govern in the computation of earnings and profits.
PART II.

PROPOSAL TO SIMPLIFY THE COMPUTATION OF EARNINGS AND PROFITS
A PROPOSAL TO SIMPLIFY THE COMPUTATION
OF EARNINGS AND PROFITS

The Need

Although there are peripheral uses, the determination of the amount of corporate earnings and profits is most frequently used for the purpose of determining if corporate distributions or other transactions having the effect of a distribution constitute dividend income by reason of their having been paid out of either current or accumulated earnings and profits. The determination of the amount of earnings and profits has, in many instances, become an extremely intricate, complex, and uncertain matter. Complexity has come from several sources: the increased complexity of the substantive law itself, the increased number of corporate combinations, and the increased number of years which have elapsed since 1913.

Acute practical problems also exist. Unless it has been making annual computations to determine earnings and profits because there is a real possibility that distributions might represent, in whole or in part, a return of capital, a corporation is not likely to compute its earnings and profits until conditions
indicate that there would be some immediate monetary consequence of the computation. Accordingly, at the time when a computation does become relevant, it is necessary to refer to historical information which frequently is not readily available, if available at all. Among other things, tax returns and revenue agents' reports from the inception of the corporation and those of all predecessor and constituent corporations must be consulted. As a practical matter, such returns, especially those of many acquired corporations which may never have been turned over to an active acquiring corporation, simply cannot be located. Other information may also be difficult to find.

Finally, the cost of preparing an earnings and profits analysis has skyrocketed. For a recently organized corporation, the cost (unless it has acquired one or more much older corporations) is relatively inexpensive. However, if there is a financial history of any consequence, the cost of preparing an earnings and profits study can quickly mount to $50,000 for even a modest-sized corporation. Moreover, even in many instances where most of the information is available, various assumptions of fact or of law must necessarily be made. The combination of complexity, unavailability of information, and cost necessarily leads to the conclusion that the present system is simply not consonant with good tax administration.
The Basic Suggestion

It is proposed that there be an alternative, which would be optional on the part of the corporation involved, to the present method of computing earnings and profits. Under this alternative, accumulated earnings and profits at the beginning of any taxable year would be determined first by reference to the excess of the total tax basis of all the corporation's assets over its liabilities. From this excess there would be deducted any amount of capital which (1) the corporation is able to demonstrate was paid in, and (2) has not been reduced as the result of prior redemptions of stock chargeable to paid-in capital. Finally, the amount would be adjusted by those items presently contained in the Code or regulations which cause earnings and profits to differ from the result which would be obtained by starting with a balance sheet prepared by using the tax basis of assets.

Support of the Suggestion

Relief has been afforded in other areas where there exists complexity, unavailability of information, and cost comparable to that encountered in an earnings and profits determination. While sec. 705(a) provides for the determination of a partner's tax basis of his partnership interest by reference to all the historical transactions affecting such partnership interest, it was recognized over 20 years ago that such information could be difficult to obtain. Accordingly, sec. 705(b) permits an alternative "net asset" approach, under which a partner's tax by reference to his share in
the partnership's tax basis, is its underlying assets.

Another approach toward simplification in perhaps an even more comparable area was the determination of the invested capital credit for purposes of the 1950-53 excess profits tax. For this purpose, the "net asset method" described in 437(c) was applicable unless an affirmative election was made under sec. 437(b)(1) to use the "historical method" provided in sec. 458.

These practical problems, which are similar to those encountered in the determination of earnings and profits, were recognized almost a generation ago, and relief was provided. They point the way toward an effective resolution of earnings and profits problems, which are becoming more acute as each year passes.

Adaptability of the Suggestion

At present, there are a number of adjustments which are made in order to determine the amount of earnings and profits and which depart from the result which would be obtained from using the tax basis of assets. Examples are the use of straight-line depreciation in lieu of accelerated depreciation, pursuant to sec. 312(k); the existence of government-insured loans, pursuant to sec. 312(i); and the requirement that depletion be determined by reference to cost depletion rather than percentage depletion, pursuant to reg. sec. 1.312-6(c). Whatever the merits of these adjustments, congressional purpose may be effectuated through adjustments of the basic suggestion. For example, it would be a relatively simple matter to adjust the result otherwise obtained
by modifying it for the excess of accelerated depreciation over straight-line depreciation which occurred in years subsequent to 1972 in order to give effect to sec. 312(k). Other adjustments could similarly be made without too much difficulty.

Comparability of Results

In view of the fact that earnings and profits are dependent primarily upon tax accounting methods, the results of the basic suggestion should be essentially the same as those presently obtained. In fact, Rev. Proc. 65-10 relies very strongly upon the net asset approach as a proof of the historical approach. The only item which would be treated differently is the "dangling debit" (or credit), illustrated in Exhibit C of Rev. Proc. 65-10. From a broad viewpoint, these dangling debits and credits appear to be of highly doubtful substantive merit, as illustrated by the situation where earnings and profits are increased as the result of a sec. 332 liquidation even though a substantial amount of the earnings and profits existed prior to acquisition and thus were, in effect, "purchased."

Dangling debits or credits will also arise from the application of Rev. Rul. 70-531. Here also, as evidenced by the litigated cases, they are of doubtful substantive merit. The suggested alternative would also eliminate the concept of pre-1913 earnings and profits. This area is one of the most difficult from a tax administration point of view because of the lapse of time. The loss of this concept from a practical point of view is relatively insignificant, and it would first be a cost of electing the optional
alternative. The status of pre-1913 earnings and profits could be retained by continuing to employ the present method of computing earnings and profits.

Summary

Some easing of the administrative burden in the earnings and profits area seems to be absolutely necessary. This proposal would eliminate the major portion of the expense represented by the tedious year-by-year analysis of operations and taxable income of the corporation and all its predecessors. Both the taxpayer and the Treasury would benefit.
PART III.

APPENDIXES

SOURCE MATERIAL ON EARNINGS AND PROFITS
### Appendix 1

**TABLE OF CASES**  
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Albrecht, Arthur A., "'Dividends' and 'Earnings and Profits'
7 Tax L. Rev. 157 (1952)

This article is an exhaustive examination of earnings and profits, exploring what constitutes a taxable dividend, the statutory definition of a dividend, the effect of statutory presumptions regarding the source of distribution, and the time of recognition of dividends as income to the recipients. Also examined are the meaning of the term "earnings and profits: and attempts to reconcile taxable net income and earnings and profits. In addition, the author considers the effect of certain transactions on earnings and profits, examining tax-free reorganizations, distributions in stock of the distributing corporation, and distributions in partial liquidation. Problems arising from distributions in kind are explored in detail.


This article is a discussion of distributions in kind, specifically distribution of inventory assets, liabilities, installment obligations, and stock of the distributing company. The article gives examples of the situation where earnings and profits are insufficient to cover property distributions. Also discussed is the effect on earnings and profits of distributions of the proceeds of government-insured loans and tax-free reorganizations and liquidations.


This article is a critical analysis of the requirement that a dividend, to be taxed as ordinary income, must be out of earnings and profits. The author explores the statutory and judicial development of the concept and its history in the case law. The author concludes that the earnings and profits concept has outlived its usefulness and recommends that the concept be dropped from the law. Return of capital distributions, the treatment of which is currently dependent upon earnings and profits, should be brought within the concept of partial liquidations by a special statutory provision.
In this article, the author discusses the possibility that earnings and profits may disappear and reappear as capital in the course of a corporate reshuffle and cites the Phipps decision as an example. This decision appears to be in direct opposition to the clear policy of the courts in Sansome and Munter that earnings and profits should not escape taxation as a result of corporate reshuffling. The Supreme Court has not ruled on this problem, which can be illustrated as follows: A subsidiary has a net deficit. The parent liquidates the subsidiary. Does the subsidiary deficit reduce earnings and profits of parent?

The author suggests that the Phipps decision may be inconsistent with the Sansome decision, which requires combining earnings and profits of parent and subsidiary profits but disallowing combination of earnings and profits and deficits.

This article is an analysis of the meaning of corporate earnings and profits by an examination of the Code and court cases and by a comparison of the elements of earnings and profits with the elements of net income for income tax purposes and with the accounting treatment of those items for general corporate purposes. Some problems discussed are the following:

1. Establishing when a stockholder will be subject to taxation for receipt of a distribution out of earnings and profits;

2. What the effect is upon earnings and profits, and what amount is taxable to the shareholder, when a distribution in kind is made and the cost and fair market value of the property are different.

This article deals with interpretation of Accounting Research Bulletin No. 48 as it applies to "poolings of
interest" where one or more of the participants remains a separate subsidiary. Specifically, it deals with the treatment of the pre-merger earned surplus of an acquired company after its liquidation into the parent.

Benesh, Marian E., "Internal Revenue Service Procedures for Determination of Accumulated Earnings and Profits" XV The Tax Executive 125 (1963)

The data required includes the following items:

1. Corporate computation of current and accumulated earnings and profits together with other applicable information.

2. Reconciliation of taxable income and earnings and profits and application of such amounts to the balance sheet to produce a tax basis balance sheet.

3. Year-by-year computation of errors in income tax to determine importance of reflection of correction for earnings and profits in the proper year.

4. For the computation of earnings and profits as to the proper year of inclusion, generally the year in which the items are "properly" reflected in taxable income is used.


This article states that there is no reason for increasing a distributor's earnings and profits on account of unrealized, unrecognized appreciation in value of an asset distributed as a dividend (or decreasing earnings and profits because of depreciation in value) and gives the following rules for the handling of dividends in kind:

1. When property distributed as a dividend in kind has a fair market value equal to its adjusted basis, earnings and profits are charged with adjusted basis -- fair market value.

2. When property distributed as a dividend in kind has a fair market value different from its adjusted basis, earnings and profits are charged for the amount of cost or adjusted basis.
3. Only to the extent that a realized gain or loss is recognized in computing net income under the law applicable to the year in which sale or disposition is made will earnings and profits be increased or decreased.

4. Sales on an installment basis do not increase earnings and profits until profits are reported in taxable income.


This article is a study of non-liquidation distributions to shareholders other than in reorganization and the effect of such distributions on the earnings and profits of the distributing corporation. Included are comprehensive discussions of the difference in treatment of a distribution of appreciated and depreciated property on earnings and profits and the import of increasing earnings and profits for dividend purposes by a nontaxable transaction. The author suggests that problems of consistency may be solved by the same treatment for inventory distributions or for non-inventory distributions. Following the statutory discussion is a summary of the basic accounting principles governing earnings and profits. Also considered are the terminology problem, tests to determine the dividend base, and the distinction made between corporate and noncorporate shareholders.

Blum, W. G., "Earnings and Profits Limitation on Dividend Income: A Reappraisal" 53 Taxes 68 (February, 1975)

This article is an extensive discussion of the complexities associated with the limitation placed on corporate dividends by earnings and profits. The author discusses fourteen "sources of complexity" arising from the dividend limitation. He also examines five arguments on behalf of the dividend limitation, discounting each as unjustified. To investigate the usefulness of the dividend limitation, he further analyzes four sets of circumstances which currently require the use of the concept of earnings and profits. The author concludes that the dividend limitation complicates tax law without any useful purpose and suggests its elimination.

The authors analyze the significant aspects arising out of Chapter X and XI bankruptcies: the recognition of income from discharge of debt, the reduction in basis of the remaining assets, investment tax credit recapture, the effects of a settlement plan on a net operating loss carryover and the effects of such a plan on earnings and profits.


The article examines some circumstances presented by a deficit in earnings and profits and discusses the resulting implications for planning opportunities and/or difficulties faced by a corporation with such a deficit.

The following problems are discussed:

1. Whether a distribution is a taxable dividend in the event of a change in stock ownership during the year because of the timing of the distribution. It is suggested that existing treatment is incorrect, despite the fact that the result is clear under present statute and regulations.

2. Whether the sale of a high-basis, low-value asset can reduce earnings and profits so that a distribution will not be treated as a dividend.

3. Items not deductible for income tax but deductible for earnings and profits are listed--premiums on life insurance, expenses relating to tax exempt income, all charitable contributions, trade, or business expenses greater than the ordinary and necessary criterion.

Bureau of National Affairs, "Earnings and Profits: General Principles and Treatments of Specific Items" Tax Management Portfolio #175 (1973)


This article is an analysis of the present law concerning the question of whether diversions of corporate funds in civil cases are taxable when there are insufficient earnings and profits to cover dividends. The Tax Court and the Sixth Circuit Court of Appeals have held that diversions of corporate funds are taxable under sec. 61 regardless of the sufficiency of earnings and profits. The Second and Eighth Circuit Courts of Appeal have held to the contrary. The author stresses the importance of the proper labeling of income and urges that an acceptable approach in criminal matters not be extended unduly into the constructive distributions area.


The authors of this article discuss corporate distributions to shareholders in the form of cash dividends, stock dividends, recapitalizations and liquidations. The article was written as a report on the American Law Institute's Income Tax Project of 1952. Proposed revisions to the income tax law are made. The article's focus is on policy, and passing reference is made to the concept of earnings and profits.


The author analyzes the regulations under sec. 964, shows the guidelines they attempt to establish, and points out the serious trouble spots to be encountered. His analysis covers the allowance of elections by the domestic shareholder, especially in the area of fixed assets and depreciation. Problems discussed include when elections have to be made and what constitutes historical cost.


This article notes that the courts look to the
substance, not the form of a transaction in determining whether there has been taxable distribution from earnings and profits. The effect of a plan is crucial in determining whether earnings and profits have in fact been distributed. The author notes that the following general rules will usually prevail:

1. A reorganization must have a business purpose;
2. Treasury stock purchases by stockholders at less than fair market value may be partially taxed as a distribution of earnings and profits;
3. Partial liquidations (if proportionate) may be a dividend;
4. Redemption of preferred stock may be taxable under sec. 115(c).

Cuddihy, James A., "Consolidated Returns" 16 NYU Annual Institute on Federal Taxation 351 (1958)

This article is a critique of the complex consolidated returns regulations. The particular items discussed are as follows:

1. Definition of the composition of an affiliated group;
2. Whether preferred stock should be excluded in computing the 95 percent ownership test;
3. Effects of lowering the affiliations test to 80 percent;
4. Period of affiliations;
5. Discontinuing consolidated returns;
6. Effect of bankruptcy or liquidation of subsidiary;
7. Corporations excluded from consolidated returns;
8. Effects of intercompany transactions;
9. Carryover limitations;

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10. Interaction with sec. 269;

11. Advantages and disadvantages of consolidated returns.


The article examines aspects of the recent amendments to the final consolidated return regulations dealing with reconciling investment adjustments with earnings and profits, clarification of the deemed dividend election, and the adjustment on disposition of a subsidiary. The author recommends that a consolidated group adjust earnings and profits currently in order to prevent duplication of tier member adjustments.


In this article the author analyzes the Baker case where the court had to decide the priority, if any, to be applied between a redemption distribution and an ordinary dividend distribution in allocating the available earnings and profits. The author points out that the court, in seeking the proper alternative, was faced with a lack of any clear direction in either the applicable statutory provision or the legislative history. The court, therefore, based its conclusion on what it thought would have been the intent of Congress if that body had been aware of the problem.

Although the judges agreed that ordinary dividend distributions should be given priority over redemption distributions in the distribution of earnings and profits, the three judges disagreed over the method of allocation. The author stresses the need for statutory reform of the earnings and profits area, concluding that the problem in Baker could have been avoided by timing the distribution so that the redemption and the ordinary dividend did not occur in the same fiscal year.
Edelstein, Haskell, "Revenue Ruling 70-531: Section 312(e) Revisited" 26 Tax L. Rev. 855 (1971)

In this article the author sets forth the fundamental defects of Rev. Rul. 70-531, as well as the technical difficulties that it generates, and argues that the statute, case law, and legislative history of sec. 312(e) deny the IRS the power to achieve its objective by administrative fiat. The author notes the failure of the ruling to deal with the unrealized appreciation surplus account and the retroactivity problems, and concludes that the ruling constitutes a fundamentally unsupportable attempt to accomplish by administrative action what can only be attained by amendment to the tax law. The fundamental defects which he cites are the following:

1. The ruling conflicts with the requirements of sec. 312(e). Sec. 312(e) says that in a redemption, the charge to the capital account is determined first; the ruling states that the charge to earnings and profits is determined first.

2. The service concludes that the capital account, but not earnings and profits, can include unrealized appreciation. The author disputes this contention.

Edelstein, Haskell and Korbell, Herbert J., "The Impact of Redemption and Liquidation Distributions on Earnings and Profits: Tax Accounting Aberrations Under Section 312(e)" 20 Tax. L. Rev. 479 (1965)

This article is a detailed analysis of the meaning and significance of sec. 312(e) in the light of the judicial and administrative determinations made. The authors have concluded that in a redemption distribution a pro rata apportionment between the capital account and earnings and profits is required under the Jarvis case; under the Woodward case the allocation formula must be used in all other terminal distributions which leave the amount of stock unchanged, whether in actuality or in essence.

The authors, however, disagree with this approach and offer two new ones called the "tax equity approach" and the "minimization of bail-out" approach. The first requires that in a terminal distribution, earnings and profits be diminished by exactly the same percentage as the percentage of stock redeemed. The second requires that earnings and profits be charged by most, if not all, of the amount in a
nonterminal distribution, and that such distribution be treated as a dividend.

The authors also recommend two statutory changes in sec. 312(e) so that (1) the capital account of the distributor includes the adjusted basis of all property which has been contributed thereto and that (2) the scope of the statute excludes those distributions in partial liquidations which would fall within sec. 332.

Edelstein, Haskell and Sitrick, James, "Earnings and Profits and the Accumulated Earnings Tax" (Edelstein), "A Reply" (Sitrick), "A Further Dissent" (Edelstein) 23 Tax L. Rev. 419 (1968)

This article is composed of a series of critiques and replies by Haskell Edelstein and James Sitrick concerning Mr. Sitrick's article "The Computation of 'Earnings and Profits' for Purposes of the Accumulated Earnings Tax," 20 Tax L. Rev. 733 (1965). Mr. Edelstein contends that the concept of earnings and profits only enters the picture in making the preliminary determination of whether the corporation is subject to the tax. He argues that the concept of earnings and profits plays no part in actually computing tax and that the accumulated earnings tax itself is to be ignored in computing the accumulated taxable income base. Mr. Sitrick, on the other hand, maintains that the amount of earnings and profits can be used to limit the amount of the accumulated earnings tax imposed.

Ellett, John S., and Schmidt, Henry W., Jr., "Section 312(m) Adds to Problems of Accounting for Depreciable Assets by Corporations" 33 J. Taxation 327 (Dec., 1970)

The authors foresee confusion regarding the application of sec. 312(m), (now sec. 312(k)), not only in the more commonplace sales and exchanges of depreciable assets, where the accountant has to beware of double-counting for earnings and profits, but also in the more infrequent cases of sec. 351 transfers and corporate separations. In projecting these difficulties, the authors demonstrate how the provision will probably apply, and suggest that perhaps when the new Treasury guidelines are issued they may produce some certainty in the tax treatment of certain utilities and real estate trusts. This, however, will by no means lessen the vast additional recordkeeping which the section requires.
The authors note that these problems will arise in all cases involving sec. 1245 or 1250 assets. The questions considered are the following:

1. In sec. 351 transfers, does the adjusted basis for earnings and profits follow the asset as does the adjusted basis for sec. 1245?

2. In corporate separations, should the earnings and profits attributable to sec. 312(k) follow specific assets with which they are related or should they be considered as part of total earnings and profits and allocated on the basis of the fair market value of assets when transferred as before?

The authors suggest that the earnings and profits should follow the particular asset.

Emmanuel, M. G., "Earnings and Profits: An Accounting Concept?" 4 Tax L. Rev. 494 (1949)

The author considers whether certain items normally considered part of capital for accounting purposes are considered part of earnings and profits for tax purposes. Although it is generally accepted that paid-in capital is part of capital, not earnings and profits, the question is not clear in cases where there have been losses and dividends are paid from paid-in surplus. Also, the question is not clear in regard to donated surplus, treasury stock surplus, and appraisal surplus, but the author concludes that these items are not necessarily removed from earnings and profits.

Everett, Ewing, "Corporate Earnings and Profits Under the Second Revenue Act of 1940" 19 Taxes 343 (JE-JL, 1941)

This article discusses the manner in which gains and losses from sale or disposition of property by a corporation and distributions received between corporations are treated in computing "earnings and profits" of the corporation under sec. 501 of the 1940 Revenue Act. The article gives the scope of the Act and the reasons for its enactment, stating that earnings and profits are not synonymous with net incomes. The author analyzes problems in computing earnings and profits and in determining the source of distributions (for example, prior to 1913). There is a thorough discussion of differences in treatment between pre- and post-1913 earnings and profits for distribution purposes.

The article attempts to demonstrate that a great deal of the uncertainty that exists in the carryover area could be dissipated if more attention were paid to the seemingly analogous situations of partial liquidation and sec. 302 redemptions. The most difficult problems remaining are caused by the limitation of sec. 356(a)(2) and the failure to require dissolution of the transferor in a "C" reorganization. The article concludes that no fully sound carryover system can be developed until these difficulties are eliminated. The partial liquidation and the stock redemption transaction, the divisive transaction, the "D" reorganization, other sec. 355 distributions, divisive transactions not qualifying under sec. 355, liquidation of subsidiaries, the amount of the carryover, and nontaxable transfers of substantially all of the assets of a corporation are topics discussed.

Harmon, Murl D., "Calculating Earnings and Profits For Foreign Subsidiaries: Background and Some Actual Results Showing Differences Among Countries" 51 Taxes 407 (July, 1973)

The author shows the reconciliation between foreign book profits and the U.S. tax concept of earnings and profits through a study of some 409 subsidiaries. This reconciliation is required for dividend payments, includible income and a minimum distribution election. He explains his use of a definition of earnings and profits according to U.S. tax law. He then describes his translation of foreign financial statements, following with examples. He makes conclusions of a general nature which relate to the overall study. No specific recommendations are set forth.

Hartline, Edward E., "Priority of Dividend Distributions Over Other Distributions as a Charge Against Earnings and Profits" 10 Houston L. Rev. 475 (1973)

This article is an analysis of stock redemptions, liquidations, and dividend distributions as a charge against earnings and profits. The article considers both the appropriateness and the priorities of each type of distribution as a charge against earnings and profits, especially against current earnings. There is an extensive discussion of Baker, which case held the following:

1. Current earnings are to be computed without diminution for redemption distributions; and
2. Ordinary dividends take precedence as a charge against current earnings in a corporation that makes both ordinary and redemptive distributions.


The article is an analysis of a number of the more important adjustments to the earnings and profits account, with a restatement of the general principles appropriate to the determination of this account. The more important adjustments considered are: (1) income taxes, (2) fraud penalties and accrued interest for tax deficiencies, (3) losses, (4) unallowable deductions for income tax but allowed for earnings and profits (for example, contributions, gifts), (5) dividends, (6) losses between related parties, (7) tax-exempt income, (8) depreciation expense. The author notes that the statute of limitations has no application to the determination of earnings and profits and that earnings and profits must be recalculated when earlier transactions (for example, court decisions) will upset the earnings and profits determination.

Herzfeld, John R., "Know Thy Earnings and Profits" 11 Tulane Tax Institute 527 (1962)

In this article, definitions, the importance of earnings and profits to the stockholders and to the corporation, the computation of current and accumulated earnings and profits, determination of earnings and profits in specific situations, and treatment of distributions are discussed at length. The article is concerned mainly with the pitfalls and the few tax planning opportunities inherent in the earnings and profits and dividend rules. Among the subjects discussed are the following:

1. Taxability of ordinary distributions and redemptions equivalent to the dividends

2. Treatment of property distributions

3. Taxability of boot in a reorganization

4. Sec. 306 stock

5. One-month liquidations

6. Distributions by subchapter S corporations as affected by earnings and profits
Hoddinott, Merle R., "Accumulation of Earnings and Profits Under Section 102 of the Internal Revenue Code" 19 Ohio Opinions 368 (Dec. 1940 - March, 1941)

This article considers the penalty taxes under sec. 104 of the Revenue Act of 1932, entitled "Accumulation of Surplus to Evade Taxes." The net worth of the plaintiff corporation in the case under discussion was increased when dividends were received. When it made payments to its creditor, its assets and liabilities were reduced, but its increase in net worth remained unchanged. This increase, the court ruled, was an accumulation of gains and profits. Taxes were assessed even though the taxpayer had said there were no earnings and profits and although the accumulation, unlike that in most accumulated earnings cases, was not obvious. Although the facts were unusual, the author contends that the results were justified because there had actually been an accumulation of earnings.

Hodgson, Paul R., "How to Determine Earnings and Profits Distributions under Section 312" P-H Tax Ideas par. 24,016

The article gives a demonstration of how to determine the amount of earnings and profits available for dividends, with emphasis on the adjustments required by sec. 312. It succinctly sets forth the adjustments to be made to taxable income and gives the order and effect of distributions from earnings and profits. There is an extensive discussion of sec. 312 as it relates to the following items:

1. Certain inventory assets,
2. Adjustment for liabilities and other items,
3. Certain distributions of stock and securities,
4. Partial liquidations and certain redemptions,
5. Effect on earnings and profits of gain or loss,
6. Effect on earnings and profits of receipt of tax-free distributions,
7. Increases in value accrued before March 1, 1913,
8. Earnings and profits of personal service corporations,
9. Allocations in certain corporate separations,
10. Distributions of proceeds of loans insured by the United States,

11. Antitrust distributions,

12. Earnings and profits of foreign investment companies, and


Huene, Herbert A., "How Will the Investment Credit Be Reflected in Earnings and Profits?" 19 J. Taxation 258 (Nov., 1963)

The article is a critical analysis of Rev. Rul. 63-63, which explains the Treasury's position regarding the effect of the investment credit on corporate earnings and profits. The author also considers the alternative methods that might be considered in charging the credit to the earnings and profits. The author contends that earnings and profits should be charged with the income tax less the investment credit in the year of acquisition of the asset giving rise to the investment credit. Alternatives would be to amortize the investment credit as a credit against income. The author contends that the IRS should abandon Rev. Rul. 63-63, which states that earnings and profits are not to be reduced by tax liability before the investment credit or the adjustment to basis of depreciable property required by sec. 48, but which does state that earnings and profits are to be reduced by the net amount of taxes paid after the investment credit.


After a discussion of the functions and general principles behind the calculation of earnings and profits, the author treats Rev. Rul. 70-531 with respect to earnings and profit adjustments in connection with redemptions and partial liquidations. He continues by citing the Luckman case on the effect on earnings and profits of compensatory transfers of stock and taxable stock dividends. The article concludes by discussing the statutory and regulatory attacks on the availability of tax-free dividends owing to depreciation methods and consolidation. The article also addresses interpretation problems under sec. 312(m) and its broad effects.
Johnson, Philip G., "Accelerated Depreciation and Subchapter S Corporations" 8 Nebraska CPA 9 (Spring, 1973)

This article is a discussion of the effects of accelerated depreciation upon the earnings and profits computation of a subchapter S corporation. The author recommends that subchapter S corporations use accelerated depreciation method only if they are fully aware of the tax consequences, pointing out that earnings and profits are decreased only by the amount of straight-line depreciation. The author points out that, in years in which distributions exceed taxable income, the shareholders can have unexpected dividend income since a distribution could come from earnings and profits.


This article addressed the inconsistencies with respect to earnings and profits and whether a redemption or a dividend takes priority in reducing earnings and profits. The author cites the Baker case, starting with the background of the applicable Code sections and the facts of this particular case. He responds to the judges' opinions and discusses other problems resulting from differences in tax treatment. His reforms include deletion of sec. 316(a)(2) and the addition of rules which provide for the determination of which distributions are to be considered made from "accumulated earnings and profits," and general simplification of the Code in this problem area. He agrees with Andrews' suggestion that distributions should be treated as a partial liquidation under a special statutory provision. He also agrees with Rudick that sec. 316(a)(2) be deleted.


In this article, the author notes that the term "earnings and profits" is vague in meaning despite the fact that the term is a touchstone in the determination of dividends. The author reviews some of the specific problems relating to cancellation of indebtedness and sale of treasury stock and discusses the timing factor of certain adjustments to earnings and profits, such as taxes, deficiencies of tax, refunds, penalties, NOL carryovers and
carrybacks, and corporate distributions. The problems of allocation and inheritance of accumulated earnings and profits and of deficits in earnings and profits in corporation separations, liquidations, and reorganizations are also addressed.

The author's conclusion calls for further statutory provisions defining "acquiring corporation" for the purposes of sec. 381 and additional sections to provide for the allocation of earnings and profits in sec. 351 transfers and for the allocation of deficits in corporate separations.

Korbel, Herbert J., "Recent Developments in the Earnings and Profits Area: Past Errors and Deficit Carryovers" 43 Taxes 494 (1965)

The article is a discussion of guidelines regarding earnings and profits developed by the courts and the Treasury with respect to soundness and scope of applicability. The author sets forth the views of the Treasury on past errors: (1) that there is no statute of limitations and (2) that there is no correction of past errors available to taxpayers because of time lapse.

With respect to deficit carryovers, the author notes that the principle in the Sansome case was codified in sec. 381. Consideration is also given to the measure of privity between the two groups of shareholders. The author's conclusion calls for Congress to spell out in detail the various ground rules to be observed with respect to earnings and profits rather than leaving the development of these rules to the courts and Treasury interpretations.


The earnings and profits section of this article discusses the addition of sec. 312(m), (now sec. 312(k)), regarding depreciation methods. This addition was meant to eliminate the payment of tax-free dividends from accelerated depreciation by some companies, especially regulated utilities and real estate companies. The problem area here is in the computation of book earnings and profits and not taxable income. The author stresses his point by using an example of this situation.
Sec. 312(k) (formerly sec. 312(m)), was enacted to correct certain abusive practices of utilities and real estate operating companies which enjoyed very large depreciation deductions. It required corporations, in determining their earnings and profits for years commencing after June 30, 1972, to deduct depreciation on the straight-line method. This article discusses the effect of the rule as applied to foreign corporations and covers other corporate problems, including the treatment of certain interests in corporations as stock or indebtedness, and redemption of stock with appreciated property. The authors state that the new sec. 385 does not define corporate interests specifically as stock or indebtedness. Sec. 311, in regard to stock redemptions with appreciated property, is designed to curb stockholders from escaping taxable gains on sales of the property. The authors suggest that this section's scope is too broad. In the area of accumulated earnings taxes, sec. 537 gives relief afforded by the provision. The article continues into the areas of interest disallowances on acquisition indebtedness, stock dividends, and multiple corporations, citing the relevant provisions of conference reports and naming some of the benefits to be derived therefrom.

LeMaster's article is a thorough investigation of the difficulties and uncertainties related to a stock repurchase plan. The author indicates that there are two major computational problems related to a stock repurchase. First, the effect of a stock repurchase on a corporation's earnings and profits depends on the effect on its shareholders. Mr. LeMaster first investigates the effect of stock repurchase on stockholders who redeem their shares. Stockholders who do not redeem their shares are the subject of the next section of the article.

With the effect on stockholders determined, the author proceeds by examining the second problem, the computation of the effect on corporate earnings and profits. The examination is a mixture of sample calculations and a proposed ideal solution. The article is concluded with five practical recommendations for corporations involved
in stock repurchases. Of primary importance, the author suggests, is that the corporation keep complete stock registers for the periods immediately before and after the closing of the repurchase transaction.


The article is a review of the provisions of sec. 312(i), relating to distributions of proceeds of government-insured loans, and of earlier attempts to tax such distributions as ordinary income under the "collapsible corporation" provisions. The author describes how to "Mortgage out" of sec. 608 by cutting building costs and distributing excess mortgage proceeds as returns of capital rather than dividends. Accordingly, the 1954 Code was expanded in the area of collapsible corporations to apply to such situations as the Gross case. The addition of the "constructive earnings" concept makes timing of distributions critical in avoiding taxable dividends to stockholders. The author further suggests that the constitutionality of this addition might be contested.

Lynch, John A., "Determination of Earnings and Profits of a Controlled Foreign Corporation" 45 Taxes 263 (April, 1967)

The author covers the determination of earnings and profits of controlled foreign corporations on a basis consistent with that of the preceding year, in accordance with regulations adopted under secs. 902 and 964. He points out the inconsistency of requiring the application of the regulations under sec. 964(a) in connection with a minimum distribution election under sec. 963 while permitting only partial use of such regulations for a normal distribution under sec. 301. He suggests that the Treasury recognize this inconsistent position and rectify it by amendment.


The article contains a detailed discussion of divisive reorganizations with particular focus on the technical statutory requirements of sec. 355. There is little emphasis upon earnings and profits.
MacLean, Charles, "Collapsible Corporations--The Statute and Regulations" 67 Harv. L. Rev. 55, 84 (1953)

This article is a detailed discussion of Code sec. 117(m), "Collapsible Corporations", added by the Revenue Act of 1950 (currently Sec. 341). After a thorough analysis of the language and implications of the section, the author concludes that the section is subject to so many restrictions that only the exceptional transaction will fall within its terms. He suggests that a more objective test is needed (e.g., comparison of taxable income for a period with net worth) to be effective in preventing taxpayer abuse.

Magill, Rosewell, "Realization of Income Through Corporate Distributions" 36 Colum. L. Rev. 519 (1936)

This article discusses the following corporation-stockholder decisions:

Hornby - realization or severance overrides element of gain;

Towne - stock dividend is not a realization of income; and

Macomber - distinction between a real stock dividend and a cash dividend, dividends in securities other than common stock, stock rights, dividends in cash and property, and corporate reorganization.

The Supreme Court has not regarded an appreciation in value of corporate stock as being income to the shareholder. In these cases, the taxability of corporate distributions is discussed, distinctions are made, and conclusions reached in light of the court's reasoning.

Mahon, James J. Jr., "New Rules as to Earnings and Profits" 13 NYU Inst. on Fed. Tax. 583 (1955)

The application of the 1954 Code has changed prior positions of the Treasury. There are new rules relating to distributions in kind which the author deals with specifically. He also considers sec. 312(i), which deals with distributions out of federally insured loans, sec. 368, which concerns allocation of earnings and profits in certain corporation separations and consolidations, carrybacks and carryovers, redemptions, and consolidated tax liability.
McCoy, Jerry J., "Revenue Ruling 70-531: Another View" 26 Tax L. Rev. 864 (1971)

This article suggests the need for objectivity in evaluating Rev. Rul. 70-531, and poses the following questions for consideration: what taxpayer practices were possible under the formerly prevalent rules; to what extent were those practices equitable, logical and necessary under the statute; how uniform were the rules of application for sec. 312(e) under the pre-Rev. Rul. 70-531 authorities; were such rules actually dictated by sec. 312(e); and finally, what changes does this latest ruling effect and why were such changes deemed necessary. The elements of sec. 312(e) and the basic problems to which Rev. Rul. 70-531 addresses itself are analyzed, and the retroactive feature of the ruling is rationalized. The article concludes that, regardless of how one views the propriety and validity of Rev. Rul. 70-531, it cannot be denied that the ruling and the problems raised thereby demonstrate the shortcomings inherent in sec. 312(e). The author recommends, therefore, that Congress conform sec. 312(e) to the pattern of sec. 312(j)(3), (formerly sec. 312(1)(3)) or abandon earnings and profits altogether.


The article illustrates the life cycle of a corporation from inception to liquidation with respect to earnings and profits. The areas discussed are the following:

1. The tax expenditure concept
2. Tax-exempt income and preferential rates for capital gains
3. Accelerated depreciation - regulations and tax expenditure approaches
4. Sec. 312(k), (previously sec. 312(m)), and ADR system
5. Other depreciation and amortization items
6. Intangible drilling and development costs
7. Investment credit
8. Disallowed deductions

9. Executive compensation devices and dividend distribution

10. Redemption and priority problems

11. Acquisitions and Liquidations

The author illustrates the complexities of earnings and profits by examples of the effects of rulings and the Code on a hypothetical corporation. The emphasis is placed on the law as it is, rather than on problems or recommendations for change.


The author focuses on the analysis of the concepts of continuity of interest and continuity of business enterprise entailed by tax planning in the area of reorganizations and the special problems of (1) recognition of income on cancellation of indebtedness, (2) basis adjustments, and (3) the availability of carryovers, including the carryover of earnings and profits.


This article is a very short discussion of the acceptable methods of allocating the consolidated liability of a group of related companies in order to determine earnings and profits. The author's point is that the method chosen for tax allocation is not binding for book and financial accounting purposes.


This article represents a brief scrutiny of two recent revenue rulings that attempt to shed some light on the IRS's posture toward sec. 355 spin-offs of divisions of related businesses. The discussion branches into an
examination of a potential retrenchment in defining what meets the active business requirement and the business purpose requirements that precludes a transfer under sec. 355 from being a mere device to bailout earnings and profits, Rev. Rul. 75-337.

Miller, Peter, "Report on Proposed Regulations on Earnings and Profits of Controlled Foreign Corporations" 42 Taxes 487 (Aug., 1964)

The author criticizes the proposed regulations (which were eventually adopted) which deal with determining a foreign corporation's earnings and profits. In brief, the author states that a divergence of accounting methods and tax practices exists and that the proposed regulations, by their narrow construction, fail to take into account the many types of foreign corporations and their ownership. He adds that the regulations fail to afford sufficient leeway for the many forms and variants of consolidation techniques. He specifically discusses the following:

1. Accounting adjustments,
2. Translation to U.S. dollars,
3. Tax adjustments,
4. Exchange gains or losses.

Mintz, Seymour and Plumb, William Jr., "Dividends in Kind--The Thunderbolts and the New Look" 10 Tax L. Rev. 41

This article discusses both the pre-1954 statutory and case law and the 1954 statutory enactments with regard to the tax treatment by the distributor corporations and the distributee shareholders of dividends in kind. The author argues that the law should be changed to achieve consistency in the amount taxable to shareholders and the amount charged to earnings and profits by the corporation in the case of non-inventory distributions.

Mirsky, B. M. and Tozzi, P. J., "Significant Recent Developments Concerning Consolidated Returns" 5 Tax Adviser 324 (June, 1974)

This article reviews and comments upon recent court decisions, published IRS rulings, and changes in the income tax regulations concerning consolidated returns. Of particular interest in the area of earnings and profits

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are rather brief discussions dealing with (1) the deletion by regulations finalized in December, 1972, of a proposed regulation that would have changed the effect a deemed dividend has on the basis of the parent's stock, and (2) amendments proposed in January, 1973, modifying the present rules to require a reduction in basis for dividends paid out of earnings and profits for any separate return limitation year.

Molloy, Robert, "Some Tax Aspects of Corporate Distributions in Kind" 6 Tax L. Rev. 57 (1950)

This article discusses whether or not a corporation should recognize income (or loss) on the appreciation (or depreciation) of property distributed as a dividend in kind. The author states the general rule that income is not to be recognized on the distribution of appreciated property and argues that the better rule with regard to the depreciated property is that loss should be recognized on its distribution.

Nesson, Charles R., "Earnings and Profit Discontinuities Under the 1954 Code" 77 Harv. L. Rev. 450 (1964)

The author explores two basic transactions, the liquidation of a subsidiary under sec. 332 and the division of a corporation into two separate corporations under sec. 355. He notes that the Code prohibits using corporations with a deficit in earnings and profits to reduce the earnings and profits of a charitable corporation and argues against this result because it creates an unbalanced tax balance sheet. After analyzing the Sansome, Phipps, and Freibro cases as well as sec. 381, the author argues for an approach which will result in a balanced tax balance sheet and preservation of historical earnings and profits.


This article deals primarily with basis problems in reorganizations but also discusses the Sansome doctrine and the need to allocate earnings and profits between parties to a reorganization in certain situations. The author states that, if the stock of the transferee is received without payment of a dividend tax, as in a tax-free spin-off, the rule requiring allocation of a portion of the transferor's earnings and profits to the transferee applies even though the transferor retains assets in an
amount at least equal to the accumulated earnings and profits. Two methods have been used for making the allocations—the relative fair market values of the assets and the relative book values. The author proposes that apportionment based on the relative basis of the assets would be a better method.


The initial purpose of the comment is to point out several situations where a periodic determination of a corporation's earnings and profits should be a matter of concern to its tax adviser. In the area of corporate distributions, this article is helpful in determining dividend policy. In the realm of accumulated earnings, a determination of earnings and profits is helpful in planning for avoidance of taxes. For liquidation under sec. 333, existence of appreciated assets requires earnings and profits computation. In subchapter S, the flow-through concept is affected by earnings and profits. The author notes that corporate taxable income and the accountant's notion of earning surplus are not the same as corporate earnings and profits.

Parkinson, Hargreaves, "What are Profits?" 85 J. of Account. (March, 1948)

This article, written on the eve of the implementation of Britain's Companies Act of 1947, deals with the differing definitions of "profits" as interpreted by different users. The author cites the need for a standardization of the term.

Paul, Randolph E., "Ascertainment of 'Earnings or Profits' for the Purpose of Determining Taxability of Corporate Distributions" 51 Harv. L. Rev. 40 (1937)

The article discusses the problems of congressional power versus legislative intent in regard to the meaning of earnings and profits. The controversial aspects of the meaning of "earnings and profits" are cited from court cases after an established definition is attempted by the author. An important test of the "source in the corporation of the distribution" for taxable dividends is discussed. The question of realized versus unrealized earnings and profits is cited as a controversial aspect of the meaning of earnings and profits. Macomber is cited as an important court case in this area. The author offers criticism of the court decisions.

This article represents an exhaustive review of the mechanics of the sec. 305 regulations, finalized in July, 1973, pertaining to restricted stock dividends falling within the ambit of sec. 305(b) as taxable under sec. 301. After examining the various situations delineated in the regulations, two classes of common, nonconvertible preferred, and common, convertible stock or securities, and redemptions, the author concludes that the guidance the regulations offer is, in at least one instance, constitutionally suspect, and not so comprehensive as to preclude future controversy.


Corporations, their shareholders, and the relations between them are discussed in this article's three parts--corporate distributions other than liquidation, corporate liquidations, and organizations and reorganizations. Corporate distributions are divided into several categories and discussed with respect to the Code; property distributions and basis problems are given major attention. On the whole, emphasis in this area is placed on the historical development of the Code sections. Citing court decisions in the area, the author suggests that the major problems in the field of corporate distributions are those dealing with the efforts of shareholders to realize what is essentially dividend income in the form of capital gains.

Petri, Enrico, "Handling E & P in Corporate Mergers, Liquidations and Reorganizations" 40 J. Taxation 48 (Jan., 1974)

The author analyzes the rules for inheriting earnings and profits on liquidations or reorganizations where one corporation has a deficit and another a positive accumulation. He discusses the treatment of earnings and profits in liquidations and acquisitive and divisive reorganizations, allocation of earnings and profits in sec. 368 "D type" and "non-D type" separations, and the possibility of circumventing taxable dividends by the elimination of earnings and profits.

He suggests that a thorough study of the rules of allocation be undertaken prior to any merger, liquidation, or divisive organization. It is also necessary that the history of earnings and profits be developed prior to any distribution of property to stockholders.
Phelps, Julian, "Unusual Accounting Questions" 28 Taxes 1227 (1950)

This article compares the definitions of tax and accounting income by tracing their development and by citing examples requiring different treatment for tax and financial reporting purposes. The author concludes that the flexibility allowed for financial reporting purposes should be extended to the concept of taxable income.

Pomeroy, Harlan, "Accumulations and Distributions of Earnings and Profits" 17 Western Res. L. Rev. 717 (Feb. 1966)

This article considers earnings and profits in relation to the penalty tax on accumulated earnings. Definitions of increases and decreases are made, and the significance of the timing of these changes as planning considerations to avoid penalty taxes are suggested.

Power, J. E., "Disposition and Acquisition of Subsidiaries: Basis; Earnings and Profits; Investment Adjustments" 31 NYU Inst. Fed. Tax 591 (1973)

The article discusses and interprets the consolidated return regulations, effective for taxable years beginning after December 31, 1965. The old and new regulations are compared and contrasted. The regulations are then explained, beginning with the essential element of the new regulations (that is, annual investment adjustments), and their effect on earnings and profits is discussed. The tax planning opportunities of the consolidated return election are exhibited, along with other planning considerations. The opportunities for tax planning occur in the deemed dividend election principally, and this is discussed through the author's use of examples.


The article is an answer to a so-called fallacy based on the assumption that tax "savings" resulting from the use of accelerated depreciation have been made the basis of a utility company's dividend pay-outs, and, as such, have been subsidized by the taxpayers. The author refutes this accusation, arguing that the utility companies in question were regulated corporations that kept their records in accordance with federal requirements. Any company books kept by these corporations are merely computations and cannot be used as the basis for the accusation.

This article sets forth the thesis that the effect of any non-liquidating distribution in kind is to decrease the distributing corporation's earnings and profits by the sum of the predistribution adjusted basis of the property distributed and the corporate tax, if any, and to increase the earnings and profits by any consideration received by the corporation, whether in the form of cash or the assumption of liabilities. The study expands on the scope and relationship of secs. 311 and 312, along with other related provisions, and discusses the following principal topics: adjustments where gain is recognized upon distribution and adjustments where gain is recognized subsequent to distribution. In discussion of the principal topics, the author uses examples to clarify his analysis. He points out the confusing and controversial provisions of secs. 311 and 312. Specific areas include the following:

1. Adjustments where gain is recognized upon distribution:
   a. Property subject to depreciation recapture
   b. Property subject to a liability
   c. Property subject to both of above
   d. LIFO inventory
   e. Installment obligations
   f. Sec. 341(f) assets

2. Adjustments where gain is recognized subsequent to distribution:
   a. Accounts receivable
   b. Shareholder sales taxed to the corporation

Raum, Leonard, "Dividends in Kind: Their Tax Aspects" 63 Harv. L. Rev. 593 (1950)

This article treats the subject of non-liquidating dividends in kind and proposes a result contrary to that eventually reached by sec. 312(a) of the 1954 Code (this article predates the enactment of that section). The author discusses the General Utilities case and circumvents its holding in his conclusion that the corporation should realize income on the appreciation of distributed property.
by treating the distribution as an anticipatory assignment of income or disregarding it under the business purpose doctrine of the Gregory case.


This article traces the progression of judicial decisions regarding the source of corporate distributions which are in part a liquidation or redemption by summarizing the decisions of several court cases: Stewart (1934), Horrmann (1936), Jarvis (1941) and Woodward (1942). Mr. Reid also traces the IRS position which was first in conflict with the courts' decisions but, later, was in agreement with them. Mr. Reid discusses the inequities in the currently governing case, Jarvis, and discusses the attempt by the IRS to alleviate the problems. The author believes that the primary issue concerning the source of distributions is whether unrealized and unrecognized appreciation should be included in the capital account. The article provides a good summary of the progress and possible future of the taxation of corporate distributions.

Reno, Edwin, "Earnings and Profits" 80 J. Accountancy 207 (1945)

This article deals with the concept of earnings and profits in tax accounting by pointing out its analogy to earned surplus in financial accounting. The effect of the following items on earnings and profits is specifically mentioned: dividends in kind, tax-free reorganization and the Sansome doctrine, stock dividends, liquidations, premiums and proceeds of life insurance policies, unrealized gross profit on installment sales, capital stock transactions, gifts to the corporation, consent dividends, personal holding company status, and regulated investment company status.


This article discusses the treatment of the earnings and profits accounts of parties to tax-free reorganizations. In particular, the article analyzes the following cases which have developed such treatment: Sansome, Phipps, and Harter.
Rice, R. S., "Minimizing Taxes on Distributions by Corporations to Shareholders Eliminating Earnings and Profits" 29 Calif. State Bar JNL 132 (1954)

This article reviews attempts to minimize the tax consequences of distributions from earnings and profits. The author notes that losses are generally not carried over in corporate reorganizations while gains are and mentions that possible tax advantages may arise where corporations with deficits are the surviving entities in merger, consolidation, and liquidation transactions.

The author also cites court cases depicting successful and unsuccessful attempts to minimize tax. The Harter decision, concerning a subsidiary liquidation, is given consideration.


This article begins with a discussion of the statutory definition of a dividend. The source of the distribution is also considered and further refined by the meaning of earnings and profits. The author suggests changes that should be made towards simplification of sec. 115 of the 1939 Code. The deductibility of certain items from profits as well as nondeductibility, is discussed, and their effects on earnings and profits are cited. Nontaxable transactions are also considered in the article.

Schlens, Edmund, "Are Earnings and Profits a Necessary Prerequisite to Treatment of a Corporate Distribution as Ordinary Income?" 45 Taxes 301 (April, 1967)

The author states generally that court cases, both criminal and civil, should follow the Code dividend rules, except possibly in clear cases of fraudulent dealings where the taxpayer has been enriched and probably will not be forced to return the funds. He cites several cases in which, in his opinion, criminal prosecution has been unwarranted. His criticism of criminal prosecution specifically names cases characterized by over-zealous prosecution.

Earnings and profits through the law, accounting principles, court decisions setting special concept apart from regular accounting, and tax liability arising from the existence of earnings and profits in certain reorganizations are analyzed. Schwanbeck discusses accumulated earnings, liquidations, and reorganizations as principal problem areas for accountants in computing earnings and profits. The author lists some of the adjustments necessary to convert retained earnings by books to earnings and profits for tax purposes. Discussing liquidations, he refers to the Sansome, Harter, Phipps, and Stratton Grain Company cases. In discussing reorganizations, he uses the Code to classify situations according to taxability. The article is primarily an introduction to the earnings and profits area.

Schwanbeck, William J., "Earnings and Profits on a Tax Basis" 8-11 MQ. Univ. Inst. of Taxation 101 (1957-60)

The author refers to applicable sections of the Code in order to define earnings and profits. He answers the question of why it is necessary or important to determine earnings and profits on a tax basis (since this amount is not required in the corporate tax return) by either areas such as corporate distributions, accumulated earnings (sec. 531), 12-month liquidations (sec. 337), income of small business corporation taxed to shareholders, other distributions of corporate property, corporate combinations liquidations, partial liquidations, divisive reorganizations and some other types of reorganizations which require the determination. The necessity of a clear picture of earnings and profits is discussed for each category.


The author states that proper determination of earnings and profits can affect the taxability of the corporation's own distributions, distributions of a successor corporation, corporate separations, and other corporate transactions. He notes that the Court decisions and IRS rules have filled the gap left by the Code and regulations in defining earnings and profits. He analyzes the rules governing earnings and profits determinations, presents planning considerations for various transactions by involving earnings and profits, and offers a checklist of adjustments. In addition to these introductory items, he analyzes the Luckman case, which held that the distribution of option stock at a price below the fair market value reduces earnings and profits by the amount of the "bargain" element.
Sitrick, James M., "The Computation of Earnings and Profits for Purposes of the Accumulated Earnings Tax" 20 Tax L. Rev. 733 (1965)

The author focuses on the computation of earnings and profits for sec. 531 tax purposes and notes that these computations are the same for sec. 531 as for dividends. Since the concept of earnings and profits is left up to the Commissioner and the courts, the author cites several court cases, principally American Metal Products Corporation, Estate of Esther M. Stein, Stern Brothers, and uses the notes from these cases as a basis for the computation of sec. 531 earnings and profits. The author notes that, in cases where accumulated taxable income exceeds earnings and profits for sec. 531, the computation for sec. 531 becomes unworkable. He stresses that the area of the law be clarified.


The author discusses the mechanics of setting up a routine for developing a cumulative computation of accumulated earnings and profits. He discusses annual reconciliations of taxable and book income and working through the tax return schedules, particularly Schedule M. He also reviews the items of income, expense, and surplus that should be given special attention.

Sparger, C. B., "Profits, Surplus and the Payment of Dividends" 8 N.C.L. Rev. 14 (1929)

This article centers around the case of Wiscassett Mills and is primarily concerned with North Carolina law. It considers the payment of dividends from (1) "Net Profit" or "Earned Surplus," (2) "Net Profit" when a "Deficit" exists, (3) "Capital Surplus," and (4) "Surplus" due to appreciation of assets.


The article is primarily an elementary discussion of the basis concepts of earnings and profits. The emphasis is placed on providing an introduction to the area for accountants rather than clarifying specific problems. One
of the problems alluded to, however, is what amount is to be charged to earnings and profits in a pro rata redemption of stock. The author concludes that the result is unclear. The phrase "earnings and profits," although containing no definition within the framework of generally accepted accounting principles and corporate law, represents a fundamental tax concept with serious consequences in the taxation of corporations and their shareholders. The article points to the rules in the Code and the regulations on the effect of certain specific transactions on earnings and profits and to the numerous court decisions and published rulings which have previously resolved litigated issues. It illustrates how various earnings and profits computations with respect to stock redemptions, timing of dividend distributions, alternate year dividends, distribution of excess assets, selection of accounting methods and installment method of accounting provide excellent tools to minimize the tax liability of stockholders.


This article merely emphasizes the point that cash and property dividends payable out of current earnings and profits or earnings and profits accumulated since February 28, 1913, are taxable.


The Stricof article is a one-column description of the proper timing of dividends and other circumstances which would allow a corporation to claim a dividend-paid deduction for determining the accumulated earnings tax and for determining undistributed personal holding company income. The description is limited in scope and barely touches on the topic of earnings and profits.

Tarlow, Edward D., "Calculation of Corporate Earnings and Profits--Cash Basis Association--Accrual of Taxes Due in Determining Earnings and Profits" 5 Boston College Industrial and Commercial L. Rev. 470 (1964)

The problem noted is whether a cash basis taxpayer can deduct federal income taxes accrued but not yet paid in computing earnings and profits. Although the regulations under sec. 316(a) states that a taxpayer must use the same accounting method in computing both taxable income and earnings and profits, the case law is split regarding deduction of taxes by cash-basis taxpayers. The author argues that allowing a deduction for taxes in computing earnings and profits for a cash-basis taxpayer is the better result.
Testa, Richard J., "Earnings and Profits After Bankruptcy Reorganization" 18 Tax Law Rev. 573 (1963)

This article deals with the question of whether or not the earnings and profits of a bankrupt corporation are to be carried over to the successor corporation following a bankruptcy reorganization. The author discusses various cases that have dealt with this matter—primarily Kavanagh and F. R. Humpage—and also discusses the application of the Sansome doctrine in such situations.

Tiedemann, William J., "Special Rules: Excess Losses; Allocation of Tax Liability; Inter-Company Liquidations and Redemptions" 31 NYU Inst. on Fed. Tax. 617 (1973)

This article deals with consolidated returns, particularly with the excess loss accounts and the allocation of federal income tax liability among members of an affiliated group. The tax basis of a member's investment in a subsidiary is increased or decreased annually by the allocable amount of the subsidiary's earnings and profits or deficit in earnings and profits. To the extent the annual adjustments result in the reduction of the basis below zero, an excess loss account is created. On disposition of the subsidiary, the member increases its earnings and profits by the amount of the excess loss account recognized.

The Code provides several methods which may be used for allocating federal income tax liability among members of an affiliated group. In addition, the consolidated return regulations provide methods which may be used; the methods provided for by the consolidated return regulations may be used after December 31, 1975, only if the group elects to adjust earnings and profits currently.

Tritt, Clyde E., "Corporate Distributions of Property" 9 USC Tax Inst. 69 (1957)

The article is an analysis of the taxability to shareholders of dividends in kind and other distributions of property, including property which has appreciated or depreciated in value, basis to the shareholders of property received through dividends in kind and other distributions, taxability of the distributor as a result of paying such other dividends or making such distributions, and other distributions of earnings and profits. The problems considered include the following:
1. By what amount does a distribution of appreciated property decrease earnings and profits?

2. To what extent is the fair market value of the appreciated property taxable to the stockholder as a dividend?

3. What is the stockholder's tax basis for the property so received?

4. Does the distribution of appreciated property create taxable income for the corporation?

5. To the extent the distribution is not taxed as a dividend, is it a return of capital or capital gain?


Mr. Tucker's article is a two-part discussion of earnings and profits as a general problem area and as a specific area of importance to life insurance companies. Mr. Tucker states that his purpose is to attempt to reconcile the concepts of taxation and earnings and profits in a logical manner which would serve as a foundation for the determination of earnings and profits for insurance companies. The article is a discussion of the earnings and profits theory and provides a step-by-step list of procedures to follow to determine the effect of particular events on earnings and profits. The remainder of Part I and all of Part II are discussions of earnings and profits-related problems for insurance companies in the area of dividends to policyholders, the small business deduction, the sec. 818(c) election, reserve strengthening or weakening, deficiency reserves, the deduction for certain accident and health and group life insurance contracts, the deduction for certain nonparticipating contracts, and one half of the excess of gain from operations over taxable investment income.

Wallace, Joseph, "Earnings and Profits: Computation for Tax Purposes is Difficult; Can Cause Unforeseen Complications" 5 Taxation for Accountants 294 (Sept., 1970)

The article is a general introduction to earnings and profits for use by accountants. No specific problem areas are discussed in detail. The problems associated with
the determination and computation of earnings and profits are many and widespread. The study sets forth guidelines for easing the difficulties arising from the interaction of certain special rules, such as the provisions on the installment method, depreciation, depletion and affiliated corporations. The article also explores the effects on earnings and profits of a distribution by a corporation of money or property to its shareholders and comments on the format for determining earnings and profits pursuant to Rev. Proc. 65-10.


The article is concerned with the issue of whether the premium portion of a distribution paid upon a redemption of preferred stock is an amount that is properly charged to the capital account of a public utility or a distribution of earnings and profits. It notes that the issuance of preferred "redeemable" stock is a conventional method of financing used by many utilities. It concludes that judicial and administrative precedent, legislative history, and sound accounting practice clearly require that a premium paid upon the redemption of preferred stock be charged to the earnings and profits of the distributing corporation, and indicates the hope that the IRS will recognize the soundness and consistency of this proposition and, by ruling accordingly in the near future, will eliminate the unnecessary confusion now beclouding the issue.

Weiner, Joseph L. and Bonbright, James C., "Surplus and Profits" 29 Colum. L. Rev. 461, 30 Colum L. Rev. 330, 954 (1930) (2 parts)

These two lengthy articles trace the development of dividend law in the Anglo-American legal system. The author comes to the conclusion that the major issue of unrealized appreciation or loss is still almost untouched in determining when there are sufficient "profits" from which to declare dividends.

Weiss, Stanley, "Earnings and Profits and the Determination of the Foreign Tax Credit" 43 Taxes 849 (Dec., 1965)

This article deals with the impact of the earnings and profits rules of subpart F on the computation of the foreign tax credit under sec. 902. The author argues that the use of the subpart F rules for such computation results
in the disregard of minor differences in accounting and tax practices between the U.S. and foreign countries and in the ability to use accounting methods which are allowable in the United States but not abroad. He concludes by recommending that the use of subpart F for such a computation be extended to U.S. interests of 50 percent or less and that the adoption of the subpart F rules be considered a method of accounting requiring the Commissioner's permission to change.

Wendt, A. P., "Wanted: A Clear, Unambiguous, Unequivocal Replacement for the Term 'Earned Surplus'" 95 J. of Account. 206 (Feb., 1953)

The author criticizes the term 'earned surplus' as being non-descriptive of the account in question. His discussion includes a review of Accounting Research Bulletin Nos. 9 and 39 (report on committee of terminology and "Discontinuance of the Term 'Earned Surplus'" respectively). He concludes that the accounting profession has yet to find suitable alternative terminology for the term "earned surplus".

Wolder, Victor and Wolder, Stanley, "The Dividend" 25 Taxes 911 (1947)

This article compares dividends under corporate law with those under federal income tax law. In the discussion of dividends under federal income tax law, the concept of earnings and profits is introduced. Specific mention is made of the effect on earnings and profits of unrealized appreciation of depreciation of assets, stock dividends and tax-free reorganizations.

Worthy, K. Martin, "Carryovers of Deductions, Credits, and Other Tax Attributes in Corporate Adjustments and Reorganizations" 44 Taxes 919 (1966)

This article discusses carryovers of certain accounting methods, elections, and specific tax attributes as applied in certain corporate adjustments and reorganizations. Emphasis is given to computation of earnings and profits for dividend purposes.

Although no specific problem areas are discussed, there is a general discussion of how earnings and profits are determined for a corporation before and after a merger or other reorganization has occurred.

The topics discussed in this article include the areas in which the concept of earnings and profits has importance, the method by which earnings and profits are computed, the effect of corporate distributions on earnings and profits, the tax consequences to the stockholders of such distributions, and the extent to which earnings and profits are carried over to a successor corporation in various corporate transactions (for example, reorganiza-


In this article, the author suggests that the current tax treatment of deferred income or credits and of reserves for estimated losses fails to accurately reflect reality. While recognizing that the allowance of a deduction for estimated expenses would entail administrative difficulties, he suggests that regulations similar to those for bad debt reserves could cover (1) maintenance, service and other guarantees, (2) cash discounts and allowances, (3) container deposits, and (4) cancellations, refunds and allowances which would sufficiently safeguard Treasury revenues.


The article is a discussion of court precedents that require a corporation to make due allowance for depreciation of tangible assets in determining state of surplus account for the purpose of declaring dividends. The problems of what to deduct as depreciation has been superseded by the 1969 Tax Reform Act.

"CA-7 Holds Cash Basis Corporation May Accrue Taxes for Earnings and Profits Determination" 19 J. Taxation 263 (Nov., 1963)

The article discusses the fact patterns and court cases establishing that, whether the corporation is on a cash or accrual basis, corporate taxes can be offset against corporate income for determination of earnings and profits. In discussing the problem of whether cash basis taxpayers may accrue Federal income and excess profits taxes in computing earnings and profits, the author does not give any
discussion of his own or reach a conclusion. The article merely states that the regulations under sec. 212 do not allow this accrual but court decisions in the 6th, 7th, and 8th Circuits, though not always consistent, have allowed the accrual.

"Corporate Reorganization and Continuity of Earning History: Some Tax Aspects" 65 Harv. L. Rev. 648 (Feb., 1952)

This article examines the major tax aspects of the continuity problems included in reorganizations which have not been expressly dealt with by statute—the carryover of earnings and profits and the carryover of unused net losses and unused excess profits credits. The article analyzes the Sansome, Harter, Munter, and Phipps cases and notes that form rather than substance often determines what the balance of the earnings and profits account is after a reorganization.


The discussion consists of a short examination of the economic nature of depreciation; a consideration of accounting techniques from the point of view of analytical jurisprudence; and a discussion of the case law. The article emphasizes the various depreciation methods and their acceptability in determining earnings and profits. The article has been superseded by the 1969 Tax Reform Act.

"Dividends - What are, for Federal Taxation" 27 Mich. Law Review 700 (April, 1929)

This article discusses the case of George Feick & Sons Co. The analysis focuses on what constitutes a severance of dividend funds from other corporate funds: (1) the effect of the declaration of a dividend, (2) the establishment of a separate fund for payment of the declared dividend, and (3) the mere intention of directors to authorize a crediting of shareholders' accounts.

"Effect of Tax-free Reorganizations on Corporate Earnings or Profits" 5 Brooklyn L. Rev. 301 (1936)

This article is an analysis of the effect of tax-free reorganizations and exchanges on corporate earnings and profits. The question is not the determination of the amount of corporate "earnings or profits," but whether the "earnings or profits" of a corporation continue
to be such, for purposes of distribution in the hands of a successor in a tax-free reorganization.

"Employee Stock Options: The Effect Upon a Corporation's Earnings and Profits" 33 MD. L. Rev. 190 (1973)

This article is a discussion of whether the difference between the market price of option stock at the time of exercise and the option price (i.e. the option spread at exercise) reduces earnings and profits. The author discusses the Divine and Luckman cases, noting that Luckman held that earnings and profits were reduced by the option spread at exercise, while the Divine case held that earnings and profits were not so reduced at that time. The author notes that although both courts differed on the time of the reduction, they were not divided on the theory of earnings and profits. The author concludes that if the theory of earnings and profits were analyzed in conjunction with stock options there should be no reduction of earnings and profits for either statutory or non-statutory stock options at the time.

"Liquidation Distributions from Earnings Since 1913 Held Taxable Under 1921 Act" National Income Tax Magazine 5:432 N. '27

This short article, consisting of two paragraphs, emphasizes that there is no difference between dividends, as defined in sec. 201 of 1921 Revenue Act, and liquidating distributions to the extent of earnings and profits accumulated since 1913. All distributions of earnings accumulated since February 28, 1913, are taxable as dividends whether the distributions are made in liquidation or otherwise.


This article discusses a case which involved a distribution in kind of a parent's subsidiary stock to the parent's shareholder. The stock had appreciated in value. The parent's earnings and profits were greater than the adjusted cost of the stock to the parent, but were less than the stock's fair market value. The court held the distribution, i.e., the fair market value, was to be taxed as ordinary income to its shareholders. The amount of the unrealized appreciation of the stock would not be added to the corporation's earnings and profits. In determining the earnings and profits after the distribution of the stock,
the distributing corporation's adjusted basis, rather than the fair market value, was the amount to be subtracted from prior earnings and profits. The author concludes with a comment that under the 1954 Code the result might be different.

"1969 Tax Reform Act: Depreciation, Earnings and Profits and Some Unexpected Results" 41 N.Y. C.P.A. 247 (March, 1971)

The article contends that the Tax Reform Act of 1969 contains many examples of the "overkill" approach, and cites sec. 312(k) as one such case. It explains that the provision was enacted to curtail the ability of certain utilities to make distributions to shareholders which would be treated as a return of capital rather than as a dividend. The new subsection has a substantially broader impact, however, particularly with respect to closely held corporations, and illustrates the application of the new rule to subchapter S corporations, and the credit for accumulated earnings tax. Problems created by sec. 312(k) will include the following:

1. Subjecting some distributions of subchapter S corporations to tax when previously they would have been tax free.

2. Confusion in the area of accumulated earnings tax regarding the $100,000 credit.

3. Shareholders under sec. 333 one-month liquidations will be required to pay higher tax.

"Reduction of Earnings and Profits to Reflect the Bargain Spread Accompanying Restricted Stock Options" 16 William and Mary Law Review 373 (Winter, 1974)

This comment exhaustively argues the position that generally accepted accounting principles (GAAP) reflect financial reality by directing a corporation to reduce earnings and profits by the amount of the bargain spread accompanying restricted stock options at the time the shares are committed to the option. This viewpoint is contrasted to current Federal Appellate Court thinking in the Second and Seventh Circuits which would defer such a reduction of earnings and profits to the time the options are exercised.


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"Revenue Ruling 70-531: A Change in the Treatment of Non-Dividend Redemptions at the Corporate Level?" 1971 Duke L. J. 453 (June, 1971)

This article discusses Rev. Rul. 70-531 which states that in every redemption distribution the charge to earnings and profits will be the pro rata share of the earnings and profits attributable to the shares redeemed. The remainder of the redemption price is chargeable to the capital account, which is incremented to include unrealized appreciation. The charge to the earnings and profits equals the pro rata portion of the total earnings and profits attributable to the redeemed shares rather than the amount remaining after the charge to the capital account, as had been the treatment in the past.

The article includes a section discussing the unrealized appreciation account. Any distribution in excess of earnings and profits and paid-in capital is charged to unrealized appreciation surplus, which is considered part of the capital account for sec. 312(e) purposes. The article states that the change to unrealized appreciation is apparently made regardless of whether such an appreciation is justified.

"Section 311(d) of the IRC, Earnings and Profits and Their Relation to Section 1248 Transactions" 55 Minn. L. Rev. 321 (1970)

This article explores the effect of the Tax Reform Act of 1969 upon a controlled foreign corporation having no earnings and profits which distributes appreciated property in a stock redemption. Prior to the 1969 Act, the U.S. stockholder receiving the distribution was allowed capital gain treatment. The effect of sec. 311(d) added by the Tax Reform Act will be to cause such distributions to be taxed at ordinary income rates. The corporation will have a simultaneous increase and decrease in earnings and profits. The corporation distributing the appreciated property will have a taxable capital gain.


This article, which discusses the Freedman case, presents the question of whether a parent's covering its subsidiary's losses, under contract, gives rise to a realizable event which will reduce the parent's earnings
and profits. The court treated reimbursing the subsidiary for its operating losses as contributions to the subsidiary's capital which were not chargeable against the parent's earnings and profits. The author questioned the outcome of the case since the subsidiary was wholly owned and filed a consolidated return with the parent. The author argued that, in this instance, parent and subsidiary earnings and profits should not have been separated.

"Stockholder Realization of Corporate Earnings and Income Tax"
17 U. Chi. L. Rev. 338 (Winter, 1950)

The determination of capital gains or ordinary income rates to shareholders of distributions of corporate earnings often depends on how the distribution is made rather than the amount of corporate earnings he receives. These transactions include: (1) cash and property dividends, (2) sales of stock by shareholders, (3) complete liquidations, (4) partial liquidations, (5) recapitalization, (6) reorganizations, (7) exchanges of like kinds of stock, and (8) stock dividends. Inequity is present whenever substantially similar tax results do not apply although the effect to the shareholder is the same. Emphasis is placed on these theoretical inequities rather than on earnings and profits as such.

"Taxation—Computations of Earnings and Profits—Cash Basis Corporation Cannot Deduct Federal Taxes Due But Yet Unpaid"
20 Vand. L. Rev. 942 (May, 1967)

Although an accrual basis corporation may reduce its current year earnings and profits by the amount of federal taxes due but not yet paid, by the amount of a contested tax liability, and by the amount of a subsequently determined deficiency, the position of a cash basis corporation is not clear. The Commissioner has asserted that a cash basis corporation cannot deduct federal taxes in determining current year's earnings and profits. The Tax Court has agreed with the Commissioner, but its positions have not always been consistent. The Circuit Courts have generally allowed cash basis taxpayers to deduct accrued taxes. The author of the article believes that the Tax Court's and the Commissioner's reasoning cannot be supported and argues for allowing the deduction.
Regulations Section 1.1502-32(d)(1)(i)

(d) Operating rules. For purposes of paragraphs (b) and (c) of this section--,

(1) Earnings and profits. (i) The earnings and profits (or deficit in earnings and profits) of a member shall be determined under sec. 1.1502-33, except that--

Regulations Section 1.1502-33(c)(4)(i-iii)

(4) Investment adjustment--(i) Taxable years beginning before January 1, 1976. Except as provided in subdivision (iii) of this subparagraph, for taxable years beginning before January 1, 1976--

(a) Adjustments made by a member under sec. 1.1502-32(e)(1) and (2), and (g) shall not be reflected in the earnings and profits of such member.

(b) For purposes of computing the earnings and profits of a member resulting from the disposition of stock of a subsidiary, the adjusted basis of such stock shall be--

(1) The adjusted basis determined without regard to adjustments under sec. 1.1502-32(e)(1) and (2), and (g), plus

(2) The amount of any excess loss account includible in income by such member under sec. 1.1502-19(a)(1) on such disposition.

(ii) Taxable years beginning after December 31, 1975. For taxable years beginning after December 31, 1975--

(a) There shall be reflected in the earnings and profits of each member for a taxable year an amount equal to any increase or decrease for such taxable year pursuant to sec. 1.1502-32(e)(1) and (2), and (g) in such member's basis or excess loss account for its stock in a subsidiary.
(b) For purposes of computing the earnings and profits of a member resulting from the disposition of stock of a subsidiary, the adjusted basis of such stock shall be determined by taking into account any adjustments under sec. 1.1502-32(e)(1) and (2), and (g).

(c) If subdivision (i) of this subparagraph applies for one or more taxable years before this subdivision applies--

(1) For purposes of computing the earnings and profits of a member resulting from the disposition of stock of a subsidiary, the adjusted basis of such stock shall be determined by taking into account any adjustments under sec. 1.1502-32(e)(1) and (2), and (g) for all consolidated return years;

(2) The negative adjustment applicable under sec. 1.1502-32(b)(2)(ii)(a) or (c)(2)(i) to distributions made in years for which this subdivision applies out of earnings and profits accumulated in years for which this subdivision did not apply shall be eliminated in computing earnings and profits; and

(3) The earnings and profits of a member disposing of stock of a subsidiary shall be (i) increased by an amount equal to the excess of the positive adjustments with respect to such stock under sec. 1.1502-32(b)(1) or (c)(1) for all years for which this subdivision did not apply, over the sum of the negative adjustments under sec. 1.1502-32(b)(2) or (c)(2) for all such years plus any adjustments under sec. 1.1502-32(b)(2)(iii)(a) or (c)(2)(i) which are described in (c)(2) of this subdivision of (ii) decreased by an amount equal to the excess of the sum of the negative adjustments with respect to such stock under sec. 1.1502-32(b)(2) or (c)(2) for all years for which this subdivision did not apply plus any adjustments under sec. 1.1502-32(b)(2)(iii)(a) or (c)(2)(i) which are described in (c)(2) of this subdivision, over the positive adjustments with respect to such stock under sec. 1.1502-32(b)(1) or (c)(1) for all years for which this subdivision did not apply.

(iii) Election to adjust currently. For any taxable year beginning before January 1, 1976, the group may elect to apply the provisions of subdivision (ii) of this subparagraph. Such election shall be made by submitting a statement, on or before the due date (including any extensions of time) of the consolidated return for the first taxable
year for which the election is to apply, to the internal revenue officer with whom the group files such return. However, such election may be made for any taxable year beginning after December 31, 1965, within 60 days after July 3, 1968, if it is made in conjunction with an election under paragraph (d) of this section. If an election is made under this subdivision for any taxable year, it may not thereafter be revoked and shall apply for all subsequent taxable years beginning before January 1, 1976.