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## THE ROLE OF "EARNINGS AND PROFITS" IN FEDERAL INCOME TAXES

No tax is imposed on a corporation's "earnings and profits" as such. This is probably the reason some practitioners feel that a determination of earnings and profits does not concern them. A prosperous corporation usually has earnings and profits in excess of any contemplated distributions to stockholders, and, consequently, such a determination of earnings and profits is thought to be of little value. The initial purpose of this 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 advisor.

### I

#### *A. Tax Treatment of Corporate Distributions*

Historically the concept of earnings and profits first entered the tax statute to exempt the distribution of pre-1913 earnings from taxation;<sup>1</sup> now it is the chief statutory basis for exempting return of contributed capital. Generally, a non-liquidating corporate distribution of cash is treated for tax purposes either as a dividend or a return of capital.<sup>2</sup> Depending upon the source of the distribution, it may be treated as ordinary income, as a return of capital, as a gain from the sale or exchange of property, or as a distribution specially exempt from tax. Section 316 of the Code defines a dividend as "any distribution . . . by a corporation to its shareholders, (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year. . . ." If the source of the distribution is from either of the above, it is a dividend and is taxed as such to the recipient. The regulations recognize four basic possible sources:<sup>3</sup>

1. Earnings and profits of the taxable year;
2. Earnings and profits accumulated since February 28, 1913;
3. Earnings and profits accumulated before March 1, 1913;
4. Sources other than earnings and profits.

Each of these sources is chargeable only to the extent that a distribution exceeds the source mentioned in the preceding class or classes. Thus, if the corporation has current year's earnings and profits (irrespective of a deficit in accumulated earnings and pro-

<sup>1</sup> BITKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, 142-143; Andrews, *Some Reflection on Taxation of Dividends*, 69 HARV. L. REV. 1403, 1404 (1956).

<sup>2</sup> INT. REV. CODE OF 1954 §301(c). Although this discussion is limited to cash distributions, comparable problems exist where the distributions are made in property other than cash.

<sup>3</sup> Treas. Reg. §1.316-2(a).

fits)<sup>4</sup> or accumulated earnings and profits since February 28, 1913 (irrespective of a lack of earnings and profits in the current year), a distribution is taxable to the shareholder as a dividend.

The source of the distribution is determined by specific statutory rules not affected by statements or designations as to the source made by corporate directors or by entries upon the corporation's books.<sup>5</sup> A corporation cannot control the taxability of distributions by designating them to be from some specific fund such as accumulated earnings prior to February 28, 1913, or paid-in surplus. There is a conclusive presumption that all such distributions are made from the most recent earnings and profits.<sup>6</sup>

A dividend declared by a corporation which does not have current earnings and profits or accumulated earnings and profits after February 28, 1913 will be treated as a return of capital and therefore tax exempt until it exceeds the stockholder's tax basis for his stock.<sup>7</sup> Any amount received in excess of the stockholder's tax basis is given capital gain treatment.<sup>8</sup>

The problem in this area is to recognize the circumstances under which a determination of earnings and profits can be beneficial in determining the dividend policy of a corporation. An examination of a dividend reporting service would show that many companies have recently declared non-taxable dividends.<sup>9</sup> If other corporations had been aware of the amount of their earnings and profits, how many dividends declared in the past would have also been tax exempt? The tax practitioner cannot assume that earned surplus is substantially the same as accumulated earnings and profits, or that net book income or taxable income is the same as the current year's increase in earnings and profits. Neither taxable income nor earned surplus correspond exactly to earnings and profits.<sup>10</sup> It is possible for a corporation to declare a dividend that is tax exempt even though the corporation had taxable income that year and earned surplus from which to declare the dividend.

Although the definition of earnings and profits will be discussed later, a few examples at this time can serve as an illustration. Many corporations declaring tax exempt dividends are those which norm-

<sup>4</sup> Stanley v. Waldheim, 25 T.C. 839 (1956), *aff'd*, 224 F. 2d 1 (7th Cir. 1957); William G. Maguire, 21 T.C. 853 (1954), *rev'd on other grounds*, 222 F. 2d 472 (7th Cir. 1955).

<sup>5</sup> Shield Co., Inc., 2 T.C. 763 (1943); MERTENS, LAW OF FEDERAL TAXATION, §9.24.

<sup>6</sup> INT. REV. CODE of 1954, §316(a).

<sup>7</sup> INT. REV. CODE of 1954, §301(c)(2).

<sup>8</sup> INT. REV. CODE of 1954, §301(c)(3). But any distribution from an increase in the value of property which accrued prior to March 1, 1913, would be tax exempt. *Id.*

<sup>9</sup> For a list of corporations declaring such dividends in 1961 see P-H FEDERAL TAX REPORT BULLETIN, Vol. LIII, No. 10 (March 8, 1962).

<sup>10</sup> Commissioner v. Wheeler, 324 U.S. 542 (1945).

ally have a substantial portion of their assets tied up in fixed depreciable property (e.g. public utilities).<sup>11</sup> An election to use accelerated depreciation (double declining balance) in determining taxable income but a more conservative method in determining book income could result in a substantial difference between earned surplus and accumulated earnings and profits. When a taxpayer elects a different method of depreciation for tax purposes, earnings and profits are also determined according to this method of depreciation.<sup>12</sup> Consequently, earnings and profits are decreasing at a faster rate or increasing at a slower rate than earned surplus.<sup>13</sup> A dividend declared from this marginal earned surplus would be a return of capital for tax purposes.

A corporation electing the installment method<sup>14</sup> for reporting taxable income on certain transactions, may also find a substantial difference between earned surplus and accumulated earnings and profits. A corporation which sells substantially appreciated property and which elects to report the gain on the installment basis but treats the entire gain as income in the present year for book purposes may find it advantageous (after a determination of accumulated earnings and profits) to distribute such a gain in the current year. Presumably, under the regulations,<sup>15</sup> this could result in a return of capital.

Even a corporation which does not have substantial adjustments to earned surplus in arriving at earnings and profits may find that the determination of their earnings and profits is of value in determining its dividend policy. In *Carl W. Lundeen*,<sup>16</sup> the majority of the stock of the Northern Transit Company (hereafter referred to as Northern) and the Northwest Motor Service Company (hereafter referred to as Northwest) were owned by one family group. The stockholders of Northern sold 94% of the common stock of Northern to Northwest in June, 1946, keeping for themselves only preferred stock. On December 28, 1946, Northern declared a \$100,000 dividend on its common stock when accumulated earnings and profits were only \$89,647. Consequently, Northwest received \$94,000,

<sup>11</sup> *Supra* note 9.

<sup>12</sup> Treas. Reg. §1.312-6(a); Corinne S. Koshland, 33 B.T.A. 634 (1935); Wells Fargo Bank & Union Trust Co. v. McLaughlin, 78 F. 2d 934 (9th Cir. 1935).

<sup>13</sup> Actually accountants may reduce this difference by a double adjustment in this area. A release by the American Institute of Certified Public Accountants requires the corporation under most circumstances to include the tax saving as an additional expense and that a deferred income tax liability be recognized for balance sheet presentation. Therefore earned surplus must be adjusted to arrive at earnings and profits by adding back deferred income taxes and subtracting the additional accelerated depreciation taken for tax purposes. See 9 J. Tax. 275 (1958).

<sup>14</sup> Int. Rev. Code of 1954, §453.

<sup>15</sup> Treas. Reg. §1.312-6(a).

<sup>16</sup> 33 T.C. 19 (1959), acq. IRB 1961-11, 7.

which they included in gross income but the 85 percent dividend-received-deduction allowed to a corporation was taken to arrive at taxable income. This dividend eliminated Northern's earnings and profits and thus permitted the corporation to declare dividends subsequently to the preferred stockholders which were a return of capital and therefore were tax exempt to the extent of each stockholder's basis. In effect, the corporation could pay dividends first to the common stockholders (the majority of such stock being owned by a corporation and therefore subject to an 85 percent deduction) and then declare a dividend to the preferred stockholders, after having eliminated all earnings and profits, resulting in a return of capital. Litigation resulted because Northwest attempted to contribute \$100,000 back to the corporation as additional paid-in capital shortly after receiving the \$94,000 common stock dividend. The court held, however, that the capital contribution was not a "rescission or refund of the dividend." The decision was based upon the lack of evidence that the \$100,000 was ever "fully" paid by Northwest to Northern and upon the fact that the other common stockholders of Northern (the remaining six percent) did not refund their dividend.<sup>17</sup> Northwest did actually contribute in excess of one-half of the dividend received from Northern, thereby making cash available to be distributed to the preferred stockholders which was tax exempt to the extent of their basis. Regardless of the fact that a subsequent contribution to capital of the dividend may rescind the dividend, two classes of stock can still be advantageous. The parties in the *Lundeen* case stipulated that if the dividend was not rescinded then it decreased earnings and profits. It would seem that where a corporation has two classes of stock, one class issued to a corporation or to individuals in a low income bracket, e.g., children of primary stockholder, that it would be possible under proper circumstances for the holders of the second class of stock to receive tax-exempt income. This, of course, assumes a strong cash position so that the amount used to pay the taxable dividend, which decreased the earnings and profits, is not needed to pay the subsequent tax exempt dividend. Under this situation the subsequent dividend could be declared from any other source permitted under the law of the state of incorporation.

#### B. *The Accumulated Earnings Tax*

Although no tax is imposed on "Earnings and Profits" as such, the Code imposes an accumulated earnings tax on the accumulated taxable income of every corporation formed or availed of for the

<sup>17</sup> In *U.S. v. Lesoine*, 203 F. 2d 123 (9th Cir. 1953), a dividend was illegal under state law and therefore rescinded. The court held that even though the dividend violated state law and was a mistake of fact, it can still be a taxable dividend if there are sufficient earnings and profits.

purpose of avoiding the income tax on its shareholders.<sup>18</sup> The purpose of this Code section is, of course, to force a corporation to distribute its earnings to the individual shareholders who would then be taxed at ordinary income rates. The accumulated earnings tax is based on taxable income for the current year less certain items.<sup>19</sup> One of these adjustments involves subtracting a minimum credit from taxable income. The practical effect of this minimum credit is exemption from the accumulated earnings tax if the accumulated earnings and profits at the close of the taxable year are \$100,000 or less.

The fact that this tax will not be imposed if the earnings and profits do not exceed \$100,000 does not mean that it necessarily will be imposed if the earnings and profits exceed \$100,000. When there is a retention in excess of \$100,000 a credit is still allowed for any excess earning and profits of the year that may be retained for the reasonable needs of the business.<sup>20</sup> The amount of earnings and profits accumulated in prior years is, of course, taken into account in determining the reasonableness of the current year's retention.<sup>21</sup> Thus, a determination of the accumulated earnings and profits is important here in ascertaining:

- 1) whether the accumulated earnings tax may be imposed, i.e., whether accumulated earnings and profits exceeds the \$100,000 minimum, and
- 2) what portion of the current earnings may be retained for the reasonable needs of the business.

When advising a corporate client in this area, the tax adviser should not rely exclusively upon the amount of earned surplus appearing on the financial statement since, as illustrated below, earnings and profits may exceed earned surplus.<sup>22</sup>

### C. Section 333 Liquidations

The concept of earnings and profits also becomes important in a Section 333 liquidation. Generally, amounts distributed in complete liquidation of a corporation will be treated under Section 331 as full payment in *exchange* for the stock. The liquidation is recognized as a taxable event to which Section 331 gives capital gain treatment. Despite this treatment, the corporation which has sub-

<sup>18</sup> INT. REV. CODE of 1954, §531-37.

<sup>19</sup> INT. REV. CODE of 1954, §535.

<sup>20</sup> INT. REV. CODE of 1954, §535(c) (1).

<sup>21</sup> 1962 P-H FEDERAL TAXES, §4711.

<sup>22</sup> See *infra* notes 26 and 27. The Trico Products Corporation paid a \$7,300,000 accumulated earnings tax over a six-year period. A minority stockholder brought an action against the directors of the corporation for allowing the corporation to become subject to the tax. The directors compromised and paid the corporation \$2,390,000. *Trico Products Corporation v. Commissioner*, 137 F. 2d 424 (2nd Cir. 1943); *Trico Products Corporation v. McGowan*, 169 F. 2d 343 (2nd Cir. 1948).

stantially appreciated assets to distribute will find that the liquidation can be detrimental to the recipient of such appreciated property. The recipient may be forced to convert the property into cash in order to pay the tax. The general effect of Section 333 is to permit qualified electing stockholders to receive appreciated property without the recognition of gain on such appreciation. A Section 333 liquidation, commonly called a "one month liquidation," in effect, transfers the basis the stockholder had for his stock, with certain adjustments, to the property received, thereby postponing the tax until the stockholder disposes of the property. To obtain this treatment, the stockholder must consent to be taxed on his share of the corporation's earnings and profits as an ordinary dividend, thereby losing the advantageous capital gain treatment that is available on this item under a Section 331 liquidation. The fact that such gain will be taxed under Section 333 as an ordinary dividend, to the extent of the earnings and profits, makes it important to ascertain the correct amount of earnings and profits before electing to come under this section.

The regulations state that an election under Section 333 cannot be withdrawn or revoked.<sup>23</sup> The reason for this restriction is to take away from the taxpayer the benefit of hindsight whereby he could shift from one position to another in light of developments subsequent to his original choice and also because such revocation would impose burdensome uncertainties upon the administration of the revenue laws.<sup>24</sup> The cases where taxpayers have attempted to withdraw such an election emphasize the need for an accurate determination of earnings and profits before making an election. Unless the election can be revoked, the detrimental effect of being taxed on earnings and profits as an ordinary dividend by electing under Section 333 can be substantial if the actual earnings and profits differ greatly from the amount anticipated when the election was made. Although the regulation<sup>25</sup> barring revocation has been held valid,<sup>26</sup> it has been qualified. In *Sam Goldman*,<sup>27</sup> the Tax Court held petitioner's election could not be revoked, but did so because of the absence of proof that there was a lack of full knowledge. In *Meyer*,<sup>28</sup> the Fifth Circuit, reversing the Tax Court, recognized the principle that "there is, under settled law, no election without full knowledge

<sup>23</sup> Treas. Reg. §1.333-2(b)(1).

<sup>24</sup> *Riley Co. Inc., v. Commissioner*, 311 U.S. 55 (1940); *Pacific National Co. v. Welch*, 304 U.S. 191 (1937); *Champlin v. Commissioner*, 78 F. 2d 905 (10th Cir. 1935).

<sup>25</sup> *Supra* note 23.

<sup>26</sup> *Raymond v. U.S.*, 269 F. 2d 181 (6th Cir. 1959); *Estate of Meyer v. Commissioner*, 200 F. 2d 592 (5th Cir. 1952), *rev'g* 15 T.C. 850 (1950).

<sup>27</sup> 50, 252 P-H T.C. Mem. (1950).

<sup>28</sup> *Estate of Meyer v. Commissioner*, 200 F. 2d 592 (5th Cir. 1952).

of the facts.”<sup>29</sup> The facts in that case showed that the stockholders “relied” on the earned surplus figure of the liquidated corporation (approximately \$80,000) as being equivalent to its earnings and profits. Actually, the earnings and profits were over \$1,000,000 due to a fifteen year old reorganization and a subsequent merger. This is, however, the only court which has applied the principle of “full knowledge.” The Tax Court<sup>30</sup> has assumed the existence of the principle but still refused to find a mistake of fact. The Sixth Circuit<sup>31</sup> held it was not a mistake of *fact* where \$50,000 of goodwill had been amortized, contrary to the regulation. The court said, “that if any mistake had occurred it was on the part of counsel and the accountant and constituted a mistake of law.” Therefore the problem is first to get the court to recognize a mistake of fact and second, to make sure it is a mistake of fact rather than a mistake of law made by the adviser (not the taxpayer).

#### D. Subchapter S Corporations

A corporation considering the advisability of avoiding tax at the corporate level by electing under Subchapter S<sup>32</sup> will find that the concept of earnings and profits can present a multitude of problems. There are many reasons for electing to be taxed under Subchapter S, such as: an elimination of the double tax, gaining the advantage of corporate fringe benefits, providing a “one shot” way to eliminate double tax on a particular transaction, and enabling a partnership to remain so for tax purposes while obtaining limited legal liability for its owners. The extent to which these problems are solved under Subchapter S can only be decided in some cases by a determination of earnings and profits and by examining the effect of future transactions upon earnings and profits.

Generally, a corporation attempting to eliminate the double tax by electing under Subchapter S will compare the net amount a shareholder will receive after taxes under both methods. It must be recognized that the double tax paid when a non-electing corporation is involved is not a double tax to the extent of the full taxable income of the corporation. The corporation is taxed upon its taxable income, but this tax is a proper deduction from earnings and profits even though not a proper deduction in arriving at taxable income. Therefore, assuming the corporation would distribute its taxable income less federal taxes, the extent to which the shareholder will gain an advantage by electing under Subchapter S will depend upon the tax bracket of the shareholders and the amount of

<sup>29</sup> *Id.* at 595. (Emphasis added).

<sup>30</sup> Estate of Lewis B. Meyer, 15 T.C. 850 (1950), rev'd 200 F. 2d 592 (5th Cir. 1952).

<sup>31</sup> Raymond v. U.S., 269 F. 2d 181 (6th Cir. 1959).

<sup>32</sup> INT. REV. CODE of 1954, §§1371-77.

income distributed by the corporation. If the election is made,<sup>33</sup> the calculation must take into consideration the loss of the shareholders' dividend credit, dividend exclusion and retirement income credit. The tax under Subchapter S must also be weighed against the possibility of receiving capital gain treatment in the future, the advantage of postponing the tax, and the possibility of shifting income from period to period if the corporation does not elect to come under Subchapter S.

When the corporation has satisfied itself that there is an overall advantage by making the election, it must then determine its earnings and profits and the effect of proposed or prospective future transactions upon earnings and profits under the Subchapter S election.<sup>34</sup>

The first problem is that it is possible to lose tax free income. The shareholder under Subchapter S must include in gross income his proportionate share of undistributed taxable income to the extent that such amount is out of earnings and profits of the taxable year.<sup>35</sup> Section 1377(b) however, states that current "earnings and profits of an electing . . . corporation for any taxable year . . . shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income. . . ."

In effect Section 1377(b) would completely disregard any decrease in current earnings and profits below taxable income. For example, if a corporation (without prior accumulated earnings and profits) had current earnings and profits of \$100,000 but taxable income of \$200,000 its shareholders would be taxed on \$200,000 regardless of the fact that earnings and profits are \$100,000 less.<sup>36</sup> In this situation a non-electing corporation could have distributed \$100,000 to the shareholder as a return of capital. A determination of earnings and profits might have revealed such a difference between earnings and profits and taxable income if it was a reoccurring difference or if the particular transaction which resulted in the difference was contemplated at the time of election. A non-deductible loss of a non-electing corporation reduces earnings and profits.<sup>37</sup> The unavailability of such a reduction for an electing corporation may offset all the tax savings that were gained by eliminating

<sup>33</sup> INT. REV. CODE of 1954, §1375(b).

<sup>34</sup> For the importance of determining accumulated earnings and profits as of the election date when future non-cash distributions are contemplated, see Swietlik, *Subchapter S*, 44 MARQ. L. REV. 470, 482 (1961).

<sup>35</sup> INT. REV. CODE of 1954, §1373.

<sup>36</sup> Treas. Reg. §1.1377-2.

<sup>37</sup> R. M. Weyerhaeuser, 33 B.T.A. 594 (1935); *Commissioner v. W. S. Forish & Co.*, 104 F. 2d 833 (5th Cir. 1939); *Dorothy Whiting Elmhurst*, 41 B.T.A. 348 (1940).

the double tax. A corporation having operating losses which have eliminated all accumulated earnings and profits and have impaired capital or paid-in surplus at the date of the election may also lose tax exempt distributions. Such an impairment of capital or of paid-in surplus in a non-electing corporation may be restored by the corporation from operating profits before any accumulated earnings and profits can be available for distribution to stockholders.<sup>38</sup>

A corporation having current earnings and profits which *exceed* taxable income also could find that Subchapter S may not be very helpful. Any distribution from current earnings and profits in excess of taxable income is treated in the same manner as an ordinary corporate dividend.<sup>39</sup> For example, a corporation using percentage depletion to determine taxable income reduces its earnings and profits only to the extent of cost depletion.<sup>40</sup> Any distribution exceeding taxable income (e.g. from the reserve for depletion) would be taxed as a dividend to the extent of earnings and profits. This is not detrimental to a corporation electing to be taxed as a Subchapter S corporation but it may eliminate any proposed savings. However, a partnership seeking limited liability by incorporation and electing under Subchapter S must remember that the way it will be taxed is not necessarily the same as it would be taxed as a partnership (or as a sole proprietor) under the same circumstances. A distribution intended as a return of capital could be a taxable dividend to the shareholders of an electing corporation.

Under Subchapter S, the shareholders are taxed on their proportionate share of taxable income regardless of whether it was distributed or not. Of course, when the shareholders include the undistributed taxable income in their individual gross income, the accumulated earnings and profits are reduced by the amount so included.<sup>41</sup> This leaves each individual shareholder a "drawing" account for tax purposes which he can withdraw at any time without it being considered a dividend.<sup>42</sup> Section 1375(d)(1) allows only an "electing" corporation to distribute these tax-paid funds without any additional tax at the shareholder level. Once the corporation is no longer an "electing" corporation, the source of any distribution is presumed to be from the most recently accumulated earnings and profits. Therefore, these tax-paid funds will be frozen in the corporation until such time as all accumulated earnings and

<sup>38</sup> *Willcuts v. Milton Dairy Co.*, 275 U.S. 215 (1927); *Commissioner v. W. S. Farish & Co.*, 104 F. 2d 833 (5th Cir. 1939).

<sup>39</sup> *Treas. Reg. §1.1377-2(b)*. But notice here that the dividend credit and exclusion are allowed stockholders of an electing corporation on such a distribution. *INT. REV. CODE OF 1954, §1375(b)*.

<sup>40</sup> *Treas. Reg. 1.312-6(c)(1)*.

<sup>41</sup> *INT. REV. CODE OF 1954, §1377(a)*.

<sup>42</sup> *INT. REV. CODE OF 1954, §1375(d)(1)*.

profits are eliminated. Since distributions are likely to be made when accumulated earnings and profits exist, if the election is terminated when tax-paid funds remain in this drawing account, there will be a second tax on the same income when it is distributed to the shareholder.<sup>43</sup>

## II

In the prior section the discussion was limited to a review of the several situations where an earnings and profits determination is important. That discussion would be incomplete if an attempt were not made to differentiate the earnings and profits concept from corporate taxable income<sup>44</sup> and from the accountant's concept of earned surplus.<sup>45</sup> The adjustments required because of these differences should be evaluated in the light of their possible effect in the areas discussed in the first part, remembering that many different adjustments, having either an offsetting or a cumulative effect, may apply to a particular corporation. The discussion here is not intended to be an exhaustive study nor is there any intent to oversimplify the possible difficulties in this area.<sup>46</sup> The classification presented is a possible starting point in analyzing the proper adjustments to be made to the accountant's earned surplus in obtaining an accurate determination of earnings and profits.<sup>47</sup>

Although it has been shown that "earnings and profits" is a term used in different sections of the Code, the latter does not at-

<sup>43</sup> The A.B.A. made a proposal in 1959 to permit a corporation whose election had terminated to distribute tax-paid funds tax-free to shareholders. See 11 J. TAX. 196 (1959).

A comparable problem exists where the election continues even after stock is sold or given to a third party. Swietlik, *supra* note 34, at 480-481.

<sup>44</sup> That is, gross income minus allowable deductions. INT. REV. CODE of 1954, §63(a).

<sup>45</sup> It should be pointed out at the beginning that for accounting purposes the term "earned surplus" is a somewhat outdated term. Accountants now use the term "retained earnings" or "earnings retained for use in the business." Generally, accountants feel that the word "surplus" can be misinterpreted. American Institute of Accountants, *Accounting Terminology Bulletin Number 1*, p. 31 (1953). The term is used in this discussion, however, because of its predominance in the legal field and in the Code.

<sup>46</sup> For further analysis see: Schwanbeck, *Earnings and Profits on a Tax Basis*, 7 MARQ. UNIV. TAX INST. 101 (1961), (condensed in 10 J. TAX. 22 (1959)); Katcher, *What Is Meant by Earnings and Profits*, 18 N.Y.U. TAX INST. 235 (1960); Andrews, *Some Reflections on Taxation of Dividends*, 69 HARV. L. REV. 1403 (1956); Alexander, *Some Earnings and Profits Aspects of the Internal Revenue Code of 1954*, 7 HASTINGS L. J. 285 (1956); Mahon, *New Rules as to Earnings and Profits*, 13 N.Y.U. TAX INST. 583 (1955); Albrecht, *Dividends and Earnings or Profits*, 7 TAX L. REV. 157 (1952); Emmanuel, *Earnings and Profits: An Accounting Concept*, 4 TAX L. REV. 494 (1949); *The Relation of Depreciation to Determination of Surplus and Earnings Available for Dividends*, 33 VA. L. REV. 581 (1947); Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law, 89 U. PA. L. REV. 865 (1941); Paul, *Selected Studies in Federal Taxation*, p. 158 (1938) (reprinted from 51 HARV. L. REV. 40 (1937)).

<sup>47</sup> For a suggested workable procedure for determining earnings and profits and the sources of data, see Schwanbeck, *supra* note 46.

tempt to define it, but merely contains some specific rules governing its computation.<sup>48</sup> It has no *exact* relation to either corporate taxable income or earned surplus. Rather, the concept's meaning has developed primarily from court decisions, rulings and regulations.

The accountant, in designating the stockholders' investment, classifies such ownership according to its source. Capital contributed by stockholders, to the extent of par or stated value, is credited to the capital stock account. Amounts in excess of the par or stated value of issued stock are designated as "additional paid-in capital." The other principal sources of additional paid-in capital are surplus from recapitalization (e.g. reduction of legal capital) and credits resulting from transactions in the corporation's own stock. Additional paid-in capital is sometimes designated surplus (i.e. capital surplus); both these terms are distinguished from earned surplus. Items such as "donated surplus" (arising from contributions without consideration, by stockholders and others) and "appraisal surplus" (arising when the fair value of fixed assets are recorded which is actually unrealized profit) are also distinguishable from earned surplus. The accountant's classification of surplus according to source is not intended to indicate how much surplus is available for dividends, although the source of the surplus provides information which may be essential to a legal determination of such amount.

The American Institute of Accountants has defined earned surplus as:

The balance of net profits, income, gains and losses, of a corporation (other than gains from transactions in its own shares, and losses therefrom, changeable to capital surplus) from the date of incorporation (or from the latest date when a deficit was eliminated in a quasi-reorganization) after deducting distributions therefrom to shareholders and transfers therefrom to capital stock or capital surplus accounts.<sup>49</sup>

Earned surplus is the retained portion of 1) net income resulting from operations, and 2) extraordinary gains such as those resulting from sales of fixed assets and investments.<sup>50</sup> The term therefore excludes capital surplus or additional paid-in capital, donated surplus and appraisal surplus.

Earnings and profits are based upon actual net income and expenses, and it would seem that this is the same as the accountant's

<sup>48</sup> INT. REV. CODE of 1954, §312.

<sup>49</sup> American Institute of Accountants, *Accounting Terminology Bulletin Number 1*, p. 16 (1953).

<sup>50</sup> H. A. FINNEY AND HERBERT E. MILLER, *PRINCIPLES OF ACCOUNTING* (Intermediate), (4th Ed., 1951).

concept of earned surplus. In *James*,<sup>51</sup> the court stated, "in employing the phrase 'earnings and profits' in the predecessor of Section 316, we think Congress intended the use of the term in the ordinary accounting understanding." This statement, standing alone, is too broad as the following discussion will demonstrate, but shows an early interpretation of Congressional intent and the basic reliance upon the accountant's concept.

I.T. 3758 states that "*in general*, it may be said that the computation of earnings and profits of a corporation for dividend purposes is based upon reasonable accounting concepts."<sup>52</sup> This statement, with a few exceptions, should readily apply to that portion of earned surplus designated as "net income resulting from operations." Operating income and expense items should follow earned surplus. Income items increase earnings and profits irrespective of the fact that: they cannot be constitutionally taxed<sup>53</sup> (e.g. interest on state and municipal bonds may be an example of this); that the income is granted statutory exemption<sup>54</sup> (e.g. life insurance proceeds),<sup>55</sup> or income relieved from taxation by an offsetting deduction or credit provision<sup>56</sup> (e.g. percentage depletion or dividend credit). The inclusion of all operating income items regardless of its tax treatment is consistent with the concept of a corporation as a tax entity separate from its stockholders. This cannot be circumvented by maintaining a separate fund.<sup>57</sup> Such tax exempt income increases the amount available to be distributed and does not require an invasion of corporate capital for a distribution.<sup>58</sup> In general, the "character" of the income is lost once it has been received by a corporation.

Actual expenditures by the corporation for operating expenses reduce earnings and profits. Even expenses which do not reduce taxable income do reduce the amount available for distribution to the stockholders. Thus, earnings and profits are reduced by such items as charitable contribution in excess of the five percent statutory limitation,<sup>59</sup> federal income taxes<sup>60</sup> recognized but disallowed

<sup>51</sup> *Commissioner v. James*, 49 F. 2d 707 (2d Cir. 1931).

<sup>52</sup> 1945 CUM. BULL. 159. (emphasis added).

<sup>53</sup> Treas. Reg. 1.312-6(b) (1955).

<sup>54</sup> *Ibid.* See Bittker, *supra* note 1, at 145, where this portion of the regulation is said to be ambiguous, in that taken in its broadest sense, it would require all income items excluded from gross income by Part III of Subchapter B of the Code to be included in earnings and profits.

<sup>55</sup> *Cummings v. Commissioner*, 73 F. 2d 477 (1st Cir. 1934). But compare Rev. Rul. 54-230, 1954-1 CUM. BULL. 114, limiting the increase in earnings and profits to the excess over total premiums paid.

<sup>56</sup> Treas. Reg. 1.312-6(b), (c) (1955).

<sup>57</sup> I.T. 2222, III-2 CUM. BULL. 12 (1925).

<sup>58</sup> Bittker, *supra* note 1, at 144.

<sup>59</sup> I.T. 3758, 1945 CUM. BULL. 159.

<sup>60</sup> *Fawcus Machine Co. v. U.S.*, 282 U.S. 375 (1931).

losses,<sup>61</sup> and possibly life insurance premiums to the extent that the premiums exceed the increase in the cash value of the policies.<sup>62</sup>

The exceptions to the rule that earnings and profits follow earned surplus in the area of net income from operations are generally 1) where the taxpayer has elected a specific treatment for tax purposes, and 2) the timing of income and expense items. With regard to these exceptions, earnings and profits follow taxable income. The requirement that the taxpayer follow taxable income where he has made a statutory election is illustrated in the following areas: the depreciation area discussed in Part I,<sup>63</sup> accrual or cash basis accounting,<sup>64</sup> installment sales,<sup>65</sup> bad debts,<sup>66</sup> and basis reduction upon cancellation of corporate indebtedness under Section 108.<sup>67</sup> This treatment of earnings and profits is consistent with the nature of an election privilege. The second exception is that the *timing* of the income or deduction follows taxable income. This timing exception presumably would include the first exception (statutory election) but the basic reason the two areas are exceptions is different. The first exception arises from an election made for tax accounting purposes while the second arises because of a business accounting treatment which deviates from permissible tax treatment. The second exception would include reserves for contingent future expenses<sup>68</sup> and excessive patent depreciation.<sup>69</sup> The timing of an increase for appreciated property or a decrease for depreciated property will also follow taxable income. Realization of gain or loss for tax purposes is based upon a taxable event which is not a controlling factor for accountants. Appreciated property (productive facilities) should not result in any adjustment because the accountant does not normally reflect such increases. If it is reflected, it would not be in earned surplus but in appraisal surplus.<sup>70</sup>

<sup>61</sup> Treas. Reg. §1.312-7(b) (1) (1955).

<sup>62</sup> MERTENS, LAW OF FEDERAL INCOME TAXATION §9.32 and §9.35. Actually there are no cases supporting this position. However, one writer has stated that there are private rulings supporting it. See Katcher, *supra* note 44, at 266. Cf. Pelton Steel Casting Co. v. Commissioner, 251 F. 2d 278 (7th Cir. 1958).

<sup>63</sup> Corinne S. Koshlard, 33 B.T.A. 634 (1935); Wells Fargo Bank and Union Trust Co. v. McLaughlin, 78 F. 2d 934 (9th Cir. 1936).

<sup>64</sup> Treas. Reg. §1.312-6; South Texas Lumber Co., 333 U.S. 496 (1948).

<sup>65</sup> Treas. Reg. 1.312-6(a); Rev. Rul. 54-230, 1954-1 CUM. BUL. 114.

<sup>66</sup> Benjamin Siegel, 29 B.T.A. 1289 (1933).

<sup>67</sup> Alabama By-Products Corp. v. U.S., 137 F. Supp. 252 (N.D. Ala. 1955), *aff'd* 228 F. 2d 958 (5th Cir. 1956); Bangor & Aroostock R. Co. v. Commissioner, 193 F. 2d 841 (1st Cir. 1951).

<sup>68</sup> Bangor & Aroostock R. Co. v. Commissioner, *supra* note 67.

<sup>69</sup> Neptune Meter Co. v. Price, 98 F. 2d 76 (2d Cir. 1938), *rehearing*, 110 F. 2d 852 (2d Cir. 1940).

<sup>70</sup> Even though unrealized gain does not increase earnings and profits, it may be possible under the laws of some states to pay dividends from such unrealized appreciation which may be treated as a return of capital if the corporation does not have earnings and profits. *Randall v. Bailey*, 288 N.Y. 280, 43 N.E. 2d 43 (1942).

Accounting principles, however, may require the reflection of any decrease in value without the necessity of a taxable event. To arrive at earnings and profits, earned surplus must be increased by any amount so reflected in the accountant's financial statement but not considered realized for tax purposes.

As previously stated,<sup>71</sup> the accountants also include in the definition of earned surplus extraordinary gains (and losses). This is merely a method used by some accountants for excluding material extraordinary items from the income statement by charging them directly to earned surplus. The accountants who advocate such an exclusion from the income statement do so because they are mindful of the particular business significance which many users attach to this statement. They point out that the inclusion of such items tend to distort the income statement. The exclusion of such items will eliminate any understatement or overstatement of income for any particular year. The exclusion of these items from current year's income as extraordinary is usually based upon either the fact that they are specifically related to prior years operations (e.g. elimination of contingent reserves), that they are related to several years (e.g. sale of fixed assets) or that they cannot be related to any particular year (e.g. losses from wars, riots, earthquakes, etc.). This method itself does not have any tax significance (since whether extraordinary gains are reflected in the income statement or not they will ultimately end up in earned surplus) although it does emphasize that a determination of earnings and profits cannot be confined to examination of the income statement. It would seem that the same principles that apply to net income from operations should apply to non-operating gains. It should be noted, however, that these transactions may more often fall within one of the exceptions noted above (e.g. both the elimination of a contingent reserve and the sale of fixed assets would be within the requirement that the timing of the income or deduction follow taxable income). Such transactions are part of the earnings history of the company and affect the amount available for distribution to stockholders as much as net income from operations.

Bookkeeping entries increasing or decreasing surplus are not conclusive in determining earnings and profits.<sup>72</sup> This rule appears to govern in areas other than net income from operations. The accountant makes entries debiting and crediting earned surplus for transactions which have no tax consequences or which are given favorable tax treatment and consequently should not be conclusive in determining the tax impact of such transactions. A tax-free re-

<sup>71</sup> *Supra* note 50.

<sup>72</sup> *Freeman v. U.S.*, 266 F. 2d 291 (6th Cir. 1959).

organization, wherein a portion of earned surplus was transferred to capital, did not decrease earnings and profits.<sup>73</sup> Contributed capital cannot be increased for tax purposes as can legal capital under state corporation law by the declaration of a non-taxable stock dividend.<sup>74</sup> These transactions have no effect on earnings and profits. Many corporations, especially during times of depression, have decreased the amount of par or stated value either to eliminate a deficit in earned surplus or in order to pay dividends. These transactions do not increase earnings and profits, even though the accountant transfers the capital surplus thereby created to earned surplus. Under corporation law the result of this transaction is to eliminate a deficit in earned surplus which frees future earnings for distribution as dividends. For tax purposes such an impairment of statutory capital (or paid-in surplus) occasioned by operating losses must be restored out of subsequent earnings before there can be distributions out of accumulated earnings and profits which are taxable as dividends, although distribution from current year's earnings and profits will be taxable during the period such an impairment is being restored.<sup>75</sup>

From this brief discussion it should be apparent that any study of a particular corporation's earnings and profits will probably end in an examination of many specific items, many of which create problems which have never been decided by the courts nor discussed in other writings.

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<sup>73</sup> Sansome, 60 F. 2d 931 (2d Cir. 1932). Cf. INT. REV. CODE of 1954 §381(c)(2).

<sup>74</sup> INT. REV. CODE of 1954, §312(d)(1)(B); August Horrman, 34 B.T.A. 1178 (1936).

<sup>75</sup> Commissioner v. W. S. Farish and Co., 104 F. 2d 833 (CCA 5th, 1939); Willcuts v. Milton Dairy Co., 275 U.S. 215 (1927).