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IV

Accumulations and Distributions of Earnings and Profits

Harlan Pomeroy

THE PENALTY TAX under section 531 of the Internal Revenue Code is imposed only in those situations in which there is the concurrence of an act (the accumulation of earnings and profits) with a state of mind (the intent to avoid income tax).[1] The required state of mind has been discussed in a preceding article.[2] The required *act* is the subject of this article.

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Under section 531, the corporation must have permitted its earnings and profits to *accumulate* instead of being divided or distributed during the particular year under scrutiny.[3] This appears to mean that (1) there must be earnings and profits, (2) the earnings and profits must have *increased* during the year, and (3) the earnings and profits must not have been divided or distributed during the year. Unless each of these three conditions is met, the statutory requirements have not been satisfied, and it is difficult to see how the section 531 penalty tax can be imposed as a matter of law.

I. EARNINGS AND PROFITS

The meaning of the phrase "earnings and profits" is a complex subject, the details of which are beyond the scope of this article.[4] However, certain fundamental principles are necessary to an understanding of the application of the penalty tax.

Earnings and profits are not necessarily the same as net profits or taxable income.[5] In order to compute the corporation's earnings

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1 See Pomeroy, *The Statutory Pattern*, 17 W. RES. L. REV. 704 (1966).

2 See Sullivan, *Prohibited Purpose for Accumulation of Earnings*, 17 W. RES. L. REV. 712 (1966).

3 INT. REV. CODE OF 1954, § 532(a) [hereinafter cited as CODE §].

4 See generally, Albrecht, *"Dividends" and "Earnings Or Profits"*, 7 TAX L. REV. 157 (1952).

5 American Metal Prods. Corp., 34 T.C. 89, 104 (1960), *nonacq. sub nom.* Adler

and profits, its net income is generally reduced by nondeductible items such as the applicable income tax and dividend distributions to shareholders. Section 312 of the Internal Revenue Code and the regulations thereunder specify in some detail how earnings and profits are to be determined. The following discussion includes, first, a consideration of some of the items which must be added to net taxable income so as to cause an *increase* in earnings and profits and, second, an analysis of some of the items which must be subtracted from net taxable income so as to result in a *reduction* of earnings and profits.

A. Increases in Earnings and Profits

For a particular year, the accumulation of earnings and profits from earlier years, *i.e.*, the earned surplus balance at the beginning of the year, is increased by the net after-tax, after-dividend income. In addition, items of exempt and nontaxable income, such as life insurance proceeds and interest on municipal bonds, are added to earnings and profits.

On the other hand, gain which is not recognized under the Internal Revenue Code[6] and unrealized appreciation in property do not increase earnings and profits.

B. Decreases in Earnings and Profits

Nondeductible items such as income taxes and dividends reduce earnings and profits. Income tax *deficiencies* may also reduce earnings and profits, although there may be a question as to whether the reduction should be made for the year to which the deficiency relates or for a later year, such as the year in which the deficiency is paid. Even the section 531 penalty itself may reduce earnings and profits.[7]

Where the corporation has a deficit in earnings and profits, no accumulation can occur, and hence no penalty can be imposed until the deficit has been cured.[8] Thus, for example, a corporation with

Metal Prods. Corp., 1963-2 CUM. BULL. 6, *aff'd*, 287 F.2d 860 (8th Cir. 1961); W. S. Farish & Co., 38 B.T.A. 150, 157-58 (1938), *nonacq.*, 1938-2 CUM. BULL. 43, *aff'd*, 104 F.2d 833 (5th Cir.), *cert. denied*, 308 U.S. 559 (1939); Treas. Reg. § 1.312-6 (1955) [hereinafter cited as Reg. §].

[6] See generally CODE § 1002.

[7] American Metal Prods. Corp., 34 T.C. 89, 104, *nonacq. sub nom.* Adler Metal Prods. Corp., 1963-2 CUM. BULL. 6, *aff'd*, 287 F.2d 860 (8th Cir. 1961).

[8] W. S. Farish & Co., 38 B.T.A. 150, 157-59 (1938), *nonacq.*, 1938-2 CUM. BULL. 43, *aff'd*, 104 F.2d 833 (5th Cir.), *cert. denied*, 308 U.S. 559 (1939); *accord*, Rev. Rul. 71, 1954-1 CUM. BULL. 71.

very substantial current earnings, such as 500,000 dollars after taxes, could not be subject to the penalty as a matter of law where prior to the current year it had a deficit of at least 400,000 dollars.

As in the case of increases in earnings and profits, unrealized depreciation in the value of assets does not affect accumulated earnings and profits.[9]

Shareholder distributions will generally decrease earnings and profits. Thus, under section 312(a), any distribution of property by a corporation with respect to its stock reduces the earnings and profits of the corporation. More specifically, such a distribution first reduces earnings and profits of the year of distribution.[10] This may not be the result, however, where the distribution is effected as part of a stock redemption. Thus, in a stock redemption qualifying for capital gain treatment under sections 302 or 303, that part of the distribution "properly chargeable to capital account shall not be treated as a distribution of earnings and profits."[11] Where the redemption involves stock the capital of which is represented by the capitalization of prior earnings, a question may arise as to whether the redemption effects a distribution or division of *current* earnings and profits. This requires a determination of whether any part of the distribution is properly chargeable to capital account and, if not, whether the amount not charged to capital account is charged first against earnings and profits of the current year.

The distribution of a nontaxable stock dividend does not reduce earnings and profits.[12] Moreover, Revenue Ruling 65-68,[13] in rejecting the holding of *Harry A. Koch Co. v. Vinal*,[14] requires that earnings capitalized upon the payment of a nontaxable stock dividend remain available for distribution as dividends for purposes of section 531. Where stock representing capitalized earnings is redeemed, the portion of the distribution in redemption not chargeable to such stock's share of *paid-in* capital is charged to and reduces earnings and profits.[15] In addition, under section 316(a), in the absence of a contrary provision in the Code, every distribution of

[9] Helvering v. National Grocery Co., 304 U.S. 282 (1938). However, such depreciation, like appreciation, may be relevant in determining whether the corporation has sufficient capital to meet its business needs.

[10] CODE § 316(a).

[11] CODE § 312(e). The same rule applies to distributions in partial liquidation.

[12] Reg. § 1.312-1(d) (1955).

[13] 1965-1 CUM. BULL. 246.

[14] 228 F. Supp. 782 (D. Neb. 1964).

[15] August Horrmann, 34 B.T.A. 1178, 1186-87 (1936).

earnings and profits is charged against the most recently accumulated earnings and profits. This general rule is applicable in determining the effect of a distribution in redemption of stock; thus a redemption distribution, to the extent that it is not charged to paid-in capital, will generally reduce current earnings and profits.[16]

II. YEAR OF INCREASE OR DECREASE IN EARNINGS AND PROFITS

A considerable body of case law has developed around the question of *when* items affecting earnings and profits are to be reflected in earnings and profits. This question can also be important in other contexts, such as where the issue is the amount of earnings and profits for purposes of measuring either the presence or the amount of a dividend to shareholders.

The year for which earnings and profits are adjusted may also be important in a section 531 case. If, in a particular year, a corporation's accumulated earnings and profits have decreased, one of the statutory conditions to application of the section 531 penalty is missing for that year.[17]

The rules as to which year's earnings and profits are reduced by taxes, tax deficiencies, penalties, and interest, or are increased by refunds of such taxes, penalties, and interest, have been distilled from a seemingly endless series of cases. The reported income tax liability of a corporation on the accrual basis of accounting generally reduces earnings and profits in the year to which the tax relates.[18] In the case of a deficiency in the income tax or in other taxes where the corporation is on the accrual basis of accounting, the deficiency generally reduces the earnings and profits for the year to which it relates, whether or not the deficiency is contested.[19]

Where the corporation is on the cash basis of accounting, some authorities follow the same rule as that applied to corporations on

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[16] For the possible significance of the fact that current earnings and profits are reduced because of the effect of items decreasing earnings and profits see text accompanying notes 23-27 *infra*. For the impact of a redemption of stock upon the question of reasonable needs of the business and the purpose to avoid shareholders' income taxes, see Pomeroy, *The Effect of Stock Redemptions Upon Tax Avoidance and the Reasonable Needs of the Business*, 17 W. RES. L. REV. 754 (1966).

[17] See text accompanying notes 23-27 *infra*.

[18] James Armour, Inc., 43 T.C. 295, 310 (1964).

[19] Stern Bros., 16 T.C. 295, 322-23 (1951), *acq.*, 1951-2 CUM. BULL. 4. A contrary result has been suggested where the deficiency is contested. Estate of Halley Tarr, 21 P-H Tax Ct. Mem. 1029 (1952).

the accrual basis,[20] while the Commissioner and other authorities require the earnings and profits to be reduced for the year in which the tax deficiency is paid.[21] Under the latter view, it might be argued that the tax paid with the return reduces earnings and profits for the year when the return is filed. This, in fact, is the rule applied to a penalty imposed in connection with the filing of a return.[22] Unlike the situation involving the proper year for deducting a contested item for income tax purposes, the above rules do not as yet seem to turn upon whether the tax or the penalty is being contested.

Dividends, and presumably other distributions to shareholders, reduce earnings and profits for the year of actual payment.[23]

III. SIGNIFICANCE OF THE ABSENCE OF CURRENT EARNINGS AND PROFITS

Under section 531, the surtax penalty for improper accumulation of earnings can be imposed only if the corporation's earnings and profits have been permitted "to accumulate instead of being divided or distributed."[24] The penalty tax is imposed annually as part of the income tax.[25] Thus, unless there has been an *accumulation* of earnings and profits during the year in question, the threshold condition for the imposition of the penalty has not been satisfied, and it would appear that the tax cannot be imposed for that year. It has been so held in one case.[26] A more recent case pointing, but not holding, to the contrary does not cite the earlier case which refused to apply the penalty on similar facts.[27] Regrettably, the later case is not clear as to the reasons for its contrary conclusion.

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20 Demmon v. United States, 321 F.2d 203 (7th Cir. 1963); Drybrough v. Commissioner, 238 F.2d 735 (6th Cir. 1956).

21 Helvering v. Alworth, 136 F.2d 812 (8th Cir.), *cert. denied*, 320 U.S. 784 (1943); Paulina duPont Dean, 9 T.C. 256, 266-67 (1947), *acq.*, 1947-2 CUM. BULL. 2; G.C.M. 2951, VII-1 CUM. BULL. 160 (1928).

22 Estate of Esther M. Stein, 25 T.C. 940, 965-66 (1956), *acq.*, 1957-2 CUM. BULL. 7, *aff'd per curiam*, 250 F.2d 798 (2d Cir. 1958); Rev. Rul. 332, 1957-2 CUM. BULL. 231.

23 Rev. Rul. 131, 1962-2 CUM. BULL. 94.

24 CODE § 532(a). "Accumulate" is defined as "To increase in quantity or number." WEBSTER, COLLEGIATE DICTIONARY (1961).

25 Corporate Inv. Co., 40 B.T.A. 1156, 1171-72 (1939), *nonacq.*, 1940-1 CUM. BULL. 6.

26 American Metal Prods. Corp., 34 T.C. 89, 104, *aff'd*, 287 F.2d 860 (8th Cir. 1961), *nonacq. sub nom.*, Adler Metal Prods. Corp., 1963-2 CUM. BULL. 6.

27 See Ted Bates & Co., P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65251 (Sept. 17, 1965). Since the judge concluded (p. 1363) that there

If the current earnings and profits have *decreased,* it is difficult to see how there can have been the *accumulation* of earnings *for that year* which is penalized by the statute. Moreover, refusal to impose the penalty in this situation would seem to be consistent with the statutory purpose of discouraging, on an annual basis, unwarranted *accumulations* of surplus. If the penalty tax is avoided in a particular year because of a net decrease in surplus, the Commissioner is entirely free to assert the penalty for prior and subsequent years.[28]

It must be remembered that there is an important distinction between determining whether there has been an *accumulation* of earnings and profits, on the one hand, and determining the *amount* of the corporation's *accumulated* taxable income on the other. The presence of an *accumulation* of earnings and profits is "jurisdictional" to the application of the penalty. In contrast, the amount of *accumulated taxable income* is the tax base or the income against which the penalty tax is applied. The penalty tax base — accumulated taxable income — is specifically and precisely defined in Subchapter G of the Code. The act of permitting an accumulation of earnings and profits, however, is determined by reference to general tax and accounting principles entirely outside Subchapter G and the provisions relating to the penalty tax on improper accumulations of earnings.

IV. CONCLUSION

This article has been confined to the determination of *whether* the *act* of permitting earnings to accumulate has been committed and does *not* relate to the determination of the amount of the accumulated taxable income and the penalty tax thereon. Thus, unless the decreases in earnings and profits during a particular year have the effect of *entirely* eliminating that year's earnings and profits, so that the act of permitting earnings to accumulate has not been committed, the decreases are not significant to our present problem. Even a slight net increase in earnings and profits during

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was a small net accumulation for the year of the redemption, his comments pertaining to the reduction of earnings and profits to reflect the stock redemption are dicta and the decision itself cannot be regarded as contrary to that in American Metal Prods. Corp., *supra* note 26.

[28] Ted Bates & Co., *supra* note 27. If the penalty is to be imposed for years in which earnings and profits have decreased, it would seem such action should be preceded by an appropriate amendment to the statute.

the current year (and hence commission of the act of permitting earnings to accumulate) will not prevent the assertion of the penalty tax against the full amount of the corporation's accumulated taxable income for the current year.

The foregoing discussion suggests a useful planning tool to avoid, or at least to be able to argue against, assertion of the penalty tax on legal grounds totally apart from the often complex factual arguments based upon the reasonable needs of the business and the subjective matter of intentions. In short, the impact on earnings and profits of items such as taxes, distributions to shareholders, and the like, may be to eliminate or substantially reduce current earnings and profits. However, if it appears that current earnings and profits will be substantially reduced, but not entirely eliminated, consideration should be given to additional items, such as distributions to shareholders, which will eliminate current earnings and profits.