Washington and Lee Law Review

Volume 15 | Issue 2 Article 16

Fall 9-1-1958

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Recommended Citation

Income Tax Deductions From Earnings And Profits, 15 Wash. & Lee L. Rev. 309 (1958).
Available at: https://scholarlycommons.law.wlu.edu/wlulr/vol15/iss2/16

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gain."[27] It would seem then that the Court of Appeals for the Ninth Circuit has treated the gain of the taxpayer in the principal case as ordinary gain in the face of the will of Congress that it be treated as long-term capital gain. This is the more interesting since it appears that the extreme position, exemplified by the *Ehrman* case, may well have prompted Congress to pass section 1237 in the first place, and since the holding in the present case seems to be even more extreme than in *Ehrman*.

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INCOME TAX DEDUCTIONS FROM EARNINGS AND PROFITS

Money distributed by a corporation to its shareholders is, in the hands of the shareholders, usually ordinary income.[1] But this is not the inevitable result. In order for the distribution to be ordinary income to the shareholder it must be a "dividend." A distribution is a "dividend" only to the extent the distributing corporation has current or accumulated "earnings and profits."[2] If there are no "earnings and profits," the part of the distribution received by each shareholder constitutes a return of capital to the extent of the shareholder's stock basis; and any excess above such basis is treated as income from the sale of a capital asset—that is, the excess is a capital gain and not ordinary income.[3]

"Earnings and profits" is a statutory concept. However, neither the Internal Revenue Code nor the Regulations attempts to define earnings and profits. On the other hand, both specify whether or not

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[27]S. Rep. No. 1622, 83d Cong., 2d Sess. 441 (1954).

[1]Distribution of property other than money involves additional problems beyond the scope of this comment. See, e.g., 1 Mertens, Federal Income Taxation §§ 9.55-9.62 (Rev. ed. 1956).

[2]"[T]he term 'dividend' means any distribution of property made 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 (computed as of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earning and profits at the time the distribution was made." Int. Rev. Code of 1954, § 316(a).

The corresponding provision of the 1939 Code was the same except for an immaterial difference in wording. See Int. Rev. Code of 1939, § 115(a), 53 Stat. 46.

[3]Int. Rev. Code of 1939, § 115(d), 53 Stat. 46, as amended, 53 Stat. 873 [now Int. Rev. Code of 1954, § 301(c)].

certain specific items are includable in, or deductible from, the earnings and profits account of a corporation. Other items have been dealt with in cases or published rulings.[4]

Although earnings and profits bears no exact relation to either taxable income or to earnings as determined by normal corporate accounting practice, it can safely be said that any item includable as taxable income in the corporation's income tax return is also includable in the corporation's earnings and profits account. Beyond that, there is a general correlation between the taxable income of a corporation and the corporation's earnings and profits, but difference in treatment exists as to certain specific items. For example: some of the corporate gain which do not constitute taxable income may be includable in the corporation's earnings and profits account;[5] some items which are deductible for corporate income tax purposes are not deductible from the corportion's earnings and profits account;[6] and some items which are not deductible for corporate income tax purposes may be deductible from the corporation's earnings and profits account.[7]

Operating losses and the costs incurred to earn income are recognized as deductible items for income tax purposes and in computing earnings and profits.[8] However, it does not follow that an arrangement giving an item the appearance of an operating loss or of a cost of earning income will result in treatment of the particular item as such in adjusting earnings and profits.

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[4]See 1 Mertens, Federal Income Taxation § 9.28 (Rev. ed. 1956).

[5]For example, tax exempt income is includable in earnings and profits. U.S. Treas. Reg. § 1.312-6(b) (1955); U.S. Treas. Reg. 118, § 39.115(a)–2(b).

On the other hand, "Where a corporation receives (after February 28, 1913) a distribution from a second corporation which . . . was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(A) no such increase shall be made in respect of the part of such distribution which . . . is directly applied in reduction of the basis of the stock in respect of which the distribution was made . . . ."

Int. Rev. Code of 1954, § 312(f)(2). For the corresponding provision in the 1939 Code, see Int. Rev. Code of 1939, § 115(1), as amended, 54 Stat. 1004 (1940).

[6]For example: mineral discovery or percentage depletion allowable for income tax purposes is not taken into consideration in computing earnings and profits. See 1 Mertens, Federal Income Taxation § 9.33 (Rev. ed. 1956).

[7]For example: charitable contributions in excess of the amount allowable as a deduction for income tax purposes are deductible for earnings and profits purposes. See 1 Mertens, Federal Income Taxation § 9.35 (Rev. ed. 1956). The idea seems to be that since such contributions diminish the assets of the corporation and are no longer available for distribution, this should be reflected in the distribution (earnings and profits) account.

[8]See 1 Mertens, Federal Income Taxation § 9.35 (Rev. ed. 1956).

In *Freedman v. United States*[9] the distributing corporation deducted from its earnings and profits account payments made to some of its subsidiaries pursuant to a contractual obligation to reimburse them for operating losses sustained. The district court decided that the parent (the distributing corporation) had improperly reduced earnings and profits by such a deduction, even though, in a consolidated income tax return, the parent had been allowed to offset losses of some subsidiaries against the income of other subsidiaries and against its own income in computing the corporate consolidated income.[10]

The parent had been organized in 1929 to acquire all the shares of several pre-existing corporations.[11] By the terms of the organizational contract the subsidiaries agreed to pay all their net profits to the parent. Also, according to testimony admitted at the trial, the parent agreed by a contemporaneous oral contract to absorb all prior losses as well as after-incurred losses of the subsidiaries during an indeterminate period of expansion. After its organization the parent carried the profits of the subsidiaries as accounts receivable and the losses as accounts payable. The parent also advanced funds to the subsidiaries from time to time, and these advancements were also carried by the parent as accounts receivable.

Later the parent received from the subsidiaries payment of all these accounts receivable, reduced by the amount of subsidiary losses. The remainder of the amounts carried in these accounts receivable was never paid by the subsidiaries because of the parent's agreement to reimburse the subsidiaries for their operating losses. Thus, in effect, the parent did reimburse the subsidiaries for their losses by reducing the amounts owed to the parent by the subsidiaries. The parent then treated these "reimbursements" as a reduction of its earnings and profits.

If this reduction were proper, the earnings and profits of the parent were insufficient to cover the entire distribution in question. Therefore, part of the distribution would not be ordinary income to the shareholder and would thus be taxable only to the extent each shareholder's pro rata share of this part exceeded his own basis in the stock. This excess over basis would be taxable only as capital gain.[12]

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[9]157 F. Supp. 613 (N.D. Ohio 1958). A new trial has been denied, and the taxpayer has appealed.

[10]See text at note 24 infra.

[11]Information not contained in the reported decision was obtained from the brief for the taxpayer, which was graciously supplied by the taxpayer's attorney, Mr. Richard Katcher, of Ulmer, Berne, Laronge, Gilckman and Curtis, B. F. Keith Bldg., Cleveland, Ohio.

[12]"(1) Amount Constituting Dividend.—That portion of the distribution which

The Commissioner rejected the parent's deduction of the loss reimbursements from its earnings and profits, thus in effect restoring the parent's earnings and profits account by the amount of these reimbursements. As a result the entire distribution became taxable to the recipient shareholders as ordinary income.

The court upheld the Commissioner, stating that such an agreement to reimburse its subsidiaries for losses, although made in good faith, did not alter the legal relationship between subsidiaries and parent, or the liability of either the shareholders or the corporations for taxes. The court reasoned that parent and subsidiary are separate entities for tax purposes; the subsidiary cannot transfer profits to the parent without first paying corporate income taxes; and consequently no tax benefit should be obtained by transferring losses. "Under the law, the obligations incurred by the subsidiary were not obligations of the parent."[13] This would seem to be true even when the contract between parent and subsidiary is considered.[14] According to the court, such absorption of losses represented an increase in the capital contribution of the parent to the subsidiary.[15] Thus, the court seems to regard the payment of these losses as a change in the form of the assets of the parent; that is, the accounts receivable are reduced, with a corresponding increase in the parent's investment in the subsidiaries. It is submitted that a change in the form of assets should have no effect on the earnings and profits of the parent.[16]

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is a dividend (as defined in section 316) shall be included in gross income.

"(2) Amount Applied Against Basis.—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

"(3) Amount in Excess of Basis.—

(A) In General.—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property." Int. Rev. Code of 1954, § 301(c). For the similar provisions of the 1939 Code, see Int. Rev. Code of 1939, § 115(d), 53 Stat. 46, as amended, 53 Stat. 873.

[13]157 F. Supp. 613 (N.D. Ohio 1958).

[14]Although the contract obligated the parent to reimburse the subsidiaries for their losses and did not obligate the parent to pay the creditors of the loss-incurring subsidiaries, this seems to be a distinction without a difference. Paying creditors in discharge of an obligation to the debtor is the same as discharging the obligation by direct payment. See Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). In Freedman the court indicated, however, that the difference influenced the result reached. But it is submitted that the same result should be reached even if the parent was obligated to pay the subsidiaries' creditors directly to the extent of subsidiaries' losses.

[15]"When the parent absorbed the losses, it did not diminish its assets for the value of its capital contribution was proportionably increased." 157 F. Supp. at 615.

[16]But see R. M. Weyerhaeuser, 33 B.T.A. 594 (1935), in which benefit assessment taxes were held deductible from earnings and profits in spite of the fact that

The requirement that a parent treat as a capital investment amounts paid to its subsidiaries by way of loss reimbursement may seem to lead to the conclusion that the less earning capacity a corporation has when acquired as a subsidiary, the greater the capital investment. However, the fact that the acquiring corporation was assuming the accumulated operating losses of the acquired corporation was undoubtedly considered when arriving at the purchase price, in whatever form it was paid to the original shareholders. The agreement to reimburse for after-incurred losses was a valid investment by the parent in the forced expansion of the subsidiaries, actually paid by the forgiveness of accounts receivable, and reflected by an increase in the basis of the stock of the subsidiaries. The court said, "If the parent had advanced cash to the subsidiary, without direction as to its use, there can be no question that the assets of the subsidiary were swelled to the extent of the advancement. The absorption of the subsidiaries' debts by the parent operates to the same effect. The parent sustained no loss in making the advancement as its capital investment was increased. The one would balance the other."[17]

What now is the status of these losses? Since the parent was not permitted to deduct them, do they no longer exist? Or is the effect of this decision to restore them, for tax purposes, to the subsidiaries involved? If the latter, do they operate to diminish the accumulated earnings and profits of the subsidiaries involved so that *their* future earnings and profits may be offset and to this extent, not constitute income to the parent when distributed by the subsidiary?

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the benefit tended to increase the value of the property. The case has been criticized on the ground that all that really occurred was a change in the form of the asset—that is, that the taxes paid were exchanged for the increased property values. See 1 Mertens, Federal Income Taxation § 9.37, n. 6 (Rev. ed. 1956). However, Weyerhaeuser actually seems distinguishable from Freedman. It was indefinite in Weyerhaeuser as to whether the entire asset had been retained in a changed form, whereas in Freedman the loss reimbursements were exactly reflected by an increase in the basis of the stock of the subsidiaries held by the parent. And this result also refutes the taxpayer's contention in Freedman that earnings and profits should be reduced by the loss reimbursements since the parent thereafter had fewer assets to distribute. Cf. note 7 supra.

[17] 157 F. Supp. at 615. Cf. Dittmar v. Commissioner, 23 T.C. 789 (1955). There was no contention of these payments being loans, in which case the taxpayer might have claimed that no capital contribution was made. See Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957). Had they been a loan, the contention might be made in an appropriate case that they were deductible as bad business debts. Seiberling Rubber Co. v. Commissioner, 169 F.2d 595 (6th Cir. 1948).

Had this been a joint venture between an individual stockholder and his corporation, with the stockholder paying the losses and receiving the profits, and with "economic consequences" to the corporation, the stockholder might have been able to deduct the losses. See Haas v. Commissioner, 248 F.2d 487, 489 (2d Cir. 1957).

Logically, these losses, since never in fact offset against subsidiary earnings and profits, should be available to the subsidiaries to reduce their earnings and profits accounts, even to the extent of creating earned deficits.[18] They were operating losses of the subsidiaries and should still be available to the subsidiaries to adjust their earnings and profits accounts.[19]

A parent's capital contribution to its subsidiary, which the court in the principal case found the loss "reimbursements" to be, does not increase the income or earnings of the subsidiary.[20] Also, although the accounting procedure used by these corporations did not reflect these losses as deductions from the subsidiaries' earnings and profits accounts, proper accounting for income tax purposes rather than for other corporate purposes is controlling.[21] Undoubtedly, prior to 1929, these losses were reflected in the income accounting of the subsidiaries when incurred, and for later years were attributed to the incurring subsidiary in the consolidated income tax returns.

Under the *Freedman* case the parent corporation itself may have benefited. As the parent's basis in the stock of the subsidiary is increased by the amount of reimbursed losses, a tax saving to the parent will result upon a future sale of stock, or liquidation, of the subsidiary.[22]

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[18]A deficit in earnings and profits can result from an operating loss. Willcuts v. Milton Dairy Co., 275 U.S. 215 (1927); Arthur C. Stifel, 29 B.T.A. 1145 (1934); Louise G. Shorb, 22 B.T.A. 644 (1931). But a deficit in earnings and profits cannot result from a distribution of assets. Van Norman Co. v. Welch, 141 F.2d 99 (1st Cir. 1944); John T. Wilson, 31 B.T.A. 1022 (1935).

[19]Except where considerations based on the date of passage of the sixteenth amendment are involved, there is, apparently, no limitation as to the time over which earnings and profits accumulations may be calculated, when determined to ascertain the nature of a current distribution. U.S. Treas. Reg. § 1.316-2 (1955); 2 Tax Research Inst., Fed. Tax Coordinator F1501 (1958). For the methods of determining which earnings and profits are conclusively presumed to be the source of a particular dividend, see U.S. Treas. Reg. §§ 1.316-1, 1.316-2 (1955). The general rule is that those earnings last earned are paid out first. Also see 1 Mertens, Federal Income Taxation § 9.53 (Rev. ed. 1956).

[20]Capital contributions are not income to the recipient. This result is reached now under § 118 of the Int. Rev. Code of 1954. "It has no counterpart in the 1939 Code; however, the rule of this section, that contributions to the capital of a corporation are excluded from income, merely restates the existing law as developed through administration and the court decisions. S. Rep. No. 1622, 83d Cong. 2d Sess. (1954); Official Explanation of the Internal Revenue Code of 1954, 24235 (Prentice-Hall 1954).

[21]"In determining the amount of earnings and profits ... due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income (or net income, as the case may be)." U.S. Treas. Reg. § 1.312-6(a) (1955).

[22]See Int. Rev. Code of 1954, § 1001 and § 331. For the corresponding provisions

As an alternative, the subsidiaries may be able to make a nontaxable distribution to the parent to the extent of these losses.[23]

To the shareholders of the parent corporation this decision results in the payment of more taxes. This could have been avoided if, in 1929, all the enterprises had been merged into a single corporate organization. It would not appear that the same result should be reached under a holding company structure. Congress has allowed such a structure to be regarded as an entity for corporate income tax purposes (by way of a consolidated return), but has not awarded the same dispensation as to distributions from a subsidiary to its parent. Instead, Congress allowed a credit for dividends received from subsidiaries, limited to 85 per cent,[24] thus indicating Congressional intent not to give the more complicated holding company structure the same tax advantages as are given to the more simple corporate organization.

ERNEST H. CLARKE

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of the 1939 Code, see Int. Rev. Code of 1939, § 111(a), 53 Stat. 37, and § 115(c), 53 Stat. 46, as amended, 64 Stat. 931 (1947).

If after the liquidation of the subsidiary the parent is to carry on the business of the subsidiary, there would probably be no gain or loss. Int. Rev. Code of 1954, § 332. There may be some doubt as to this result. See Fairfield Steamship Corp. v. Commissioner, 157 F.2d 321 (1946) (dictum). See also U.S. Treas. Reg. § 1.332-2 (1955).

[23]But, even if a distributing subsidiary has a deficit in its accumulated earnings and profits account, the subsidiary must not pay the distribution during any year in which it has earnings or the distribution will be taxable as ordinary income, since the distribution will be deemed to have been paid from current earnings and profits. Int. Rev. Code of 1954, § 316(a)(2). See Stanley W. Waldheim, 25 T.C. 839 (1956). For the rule applicable before 1939, see Commissioner v. W. S. Farish Co., 104 F.2d 833 (5th Cir. 1939). The present rule was first added by Int. Rev. Code of 1939, § 115(a), 53 Stat. 46.

[24]Int. Rev. Code of 1954, § 243.