Adjusting Earnings and Profits Under Internal Revenue Code Section 312(e)

Mark L. Regante
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SECTION 312(e)

INTRODUCTION

“Earnings and profits” was first utilized as a term of art in the realm of corporate taxation in the Revenue Act of 1916. A section of that Act provided, without elaboration, that “‘dividends’ . . . shall be held to mean any distribution made or ordered to be made by a corporation . . . out of its earnings or profits . . . .” Earnings and profits thus serves as a determinant of the tax effect of a distribution made in the ordinary course of business by a corporation to its shareholders. To the extent that there are corporate earnings and profits, a distribution will be taxed as a dividend to the shareholders. Where the amount of the distribution exceeds existing earnings and profits, however, shareholders will be treated as having received either a nontaxable return of capital or the gain from the sale or exchange of a capital asset. The amount of earnings and profits is equally significant to the corporation. If earnings and profits are permitted to accumulate beyond the “reasonable needs of the business,” the corporate entity will subject itself to the harsh consequences of the accumulated earnings tax.

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2 Id. The Revenue Act of 1913, Pub. L. No. 16, ch. 16, 38 Stat. 166, taxed all distributions without regard to their source. Id. § II(B)[1]. Shortly after the March 1, 1913 effective date of the Act, the decision of the Eighth Circuit in Lynch v. Turrish, 236 F. 653 (8th Cir. 1916), aff’d, 247 U.S. 221 (1918), raised doubts as to the constitutionality of taxing distributions derived from earnings of the corporation accumulated prior to the 1913 Act. Congress thereupon enacted § 2(a).
3 See I.R.C. § 316(a). To a noncorporate shareholder, dividends are fully includable in gross income, id. § 61(a)(7), except to the extent of the $100 exclusion provided by I.R.C. § 116(a). The corporate shareholder includes the full amount in gross income, id. § 61(a)(7), but is permitted a deduction in the amount of 85% of the dividends so included in gross income. Id. § 243(a)(1). Thus, only 15% of the dividends received will be taxable as income to a corporate shareholder.
4 See id. § 301(c). I.R.C. § 301(c)(2) provides: “That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.” Thus, upon a subsequent sale of the stock, the portion of the distribution treated as a reduction in the shareholder’s basis will take on the characteristics of any gain or loss then incurred. Under I.R.C. § 301(c)(3)(A), “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.” In the hands of the ordinary investor, such gain will be treated as the gain from the sale or exchange of a capital asset, see id. § 1221, and, depending on the length of time the shareholder has held the stock, will be taxed as either a long- or short-term capital gain. See id. § 1222(1), (3).
5 Id. § 537.
6 Id. §§ 531-537. The accumulated earnings tax is imposed in addition to the other taxes
Although no definition of the term appears in the Internal Revenue Code, certain transactions and events which affect earnings and profits are enumerated therein. This legislative guidance, coupled with the insight that may be culled from judicial decisions, has lent some measure of clarity to the concept of earnings and profits. Basically, earnings and profits represents the aggregate of the annual noncapital increases or decreases in the net worth of a corporation. Since the characterization of a distribution as a dividend is contingent upon the presence of earnings and profits, a distribution treated as a dividend will reduce the amount of corporate earnings and profits available for subsequent dividend distributions.

Prior to 1924, all distributions were conclusively presumed to have been derived from the most recently accumulated earnings and profits. In that year, however, Congress, apparently recognizing that some distributions may constitute, at least in part, a return of the shareholders’ investments, enacted section 201(c) of the Revenue Act of 1924. Under this section, amounts distributed in partial or complete liquidation of a corporation were treated as payments for which the corporation is liable. The tax is “equal to the sum of—(1) 27½ percent of the accumulated taxable income not in excess of $100,000 . . . .” Id. § 531. The definition of “accumulated taxable income” is designed to approximate the excess of the increase in a corporation’s assets during the taxable year over the “reasonable needs of the business.” See id. § 535.

I.R.C. § 312 is the principle Code section delineating the increase or decrease to earnings and profits occasioned by various transactions. The section includes provisions for reducing earnings and profits upon distributions by the corporation to its shareholders, id. § 312(a)-(e), increasing or decreasing earnings and profits when gain or loss from the sale of property is recognized, id. § 312(f)(1), and limiting the amount of depreciation which can be taken into account in the computation of earnings and profits, id. § 312(k). Treas. Reg. § 1.312 (1977), provides illustrations of the manner in which many of § 312’s provisions operate. By comparing earnings and profits to “surplus” and providing that “the amount of earnings and profits . . . will be dependent upon the method of accounting properly employed in computing taxable income (or net income as the case may be),” Treas. Reg. § 1.312-6(a) (1960) indicates a possible starting point for the computation of earnings and profits. It is only through this vague reference to taxable income that the Code and Regulations intimate that the expenses of the business reduce earnings and profits.


See I.R.C. § 312(a).


made in exchange for its stock.\textsuperscript{13} As a consequence, the amount received by a shareholder under such a distribution would be entitled to capital gain treatment. If these distributions were chargeable solely to earnings and profits, an artificial reduction of earnings and profits would be occasioned thereby,\textsuperscript{14} possibly resulting in a subsequent distribution being deemed in whole or in part a tax free return of capital.\textsuperscript{15} It thus became clear that distributions in partial or complete liquidation, as distinguished from ordinary dividend distributions, could not be charged entirely to earnings and profits. In recognition of this factor, Congress provided in section 201(c) of the Revenue Act of 1924 that “the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits . . . for the purpose of determining the taxability of subsequent distributions by the corporation.”\textsuperscript{16}

The present version of this rule is embodied in section 312(e) of the Internal Revenue Code. By virtue of the Revenue Act of 1954, this section is applicable to redemptions consummated under sections 302(a)\textsuperscript{17} and 303,\textsuperscript{18} in addition to liquidations. Except for this

\textsuperscript{13} Id. Section 201(c) provided in pertinent part: “Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock.” Id. § 201(c). Section 201(g) of the Act defined a partial liquidation as “a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.” Id. § 201(g). The scope of the partial liquidation concept has since been substantially expanded. See I.R.C. § 346.

\textsuperscript{14} Significantly, a distribution treated as a payment in exchange for stock is deemed to have originated in a sale or exchange of a capital asset, and thus qualifies for the capital gains deduction of I.R.C. § 1202 and the alternative tax treatment of § 1201. Such treatment is clearly advantageous to a noncorporate shareholder. A corporate shareholder might not prefer sale or exchange treatment, however, since the § 1202 capital gains deduction is not available to corporations. Moreover, the corporation is entitled to an 85\% deduction for dividends received, id. § 243, while it is taxed to the full extent of the gain received from a distribution in partial liquidation. Thus, whenever a corporate shareholder’s basis is less than 85\% of the amount distributed to it, a smaller tax will result to it under dividend taxation, and its basis with respect to its remaining shares will not be reduced.

\textsuperscript{15} See note 10 and accompanying text supra.

\textsuperscript{16} See text accompanying note 4 supra.

\textsuperscript{17} Revenue Act of 1924, Pub. L. No. 176, ch. 234, § 201(c), 43 Stat. 255.

\textsuperscript{18} I.R.C. § 302 exempts from dividend treatment certain distributions in redemption of a shareholder’s stock. Id. § 302(a). The redemptions which qualify are those which are: “not essentially equivalent to a dividend,” id. § 302(b)(1); “substantially disproportionate with respect to the shareholder,” id. 302(b)(2)(A), within the meaning of § 302(b)(2); in complete termination of the shareholder’s interest, id. § 302(b)(3); and “of stock issued by a railroad corporation . . . pursuant to a plan of reorganization under section 77 of the Bankruptcy Act,” id. § 302(b)(4). Although § 302(b)(2)-(4) provides a relatively objective standard for determining inclusion under § 302(a), a large body of case law has evolved dealing with the determination of “dividend equivalence” in applying § 302(b)(1). See, e.g., United States v.
broadening of its scope, the statutory language has remained almost unchanged since its initial enactment as section 201(c) in 1924. Upon examining this language, it becomes evident that the operation of section 312(e) hinges on the meaning assigned to the phrase "amount properly chargeable to capital account." As these words were not defined by Congress and are not explained in the relevant Treasury Regulations, some controversy with respect to their import has developed. In the main, there have emerged three distinct solutions to the problems posed by the lack of an authoritative definition. This Note will examine these three approaches, focusing upon the manner in which each would determine the amount of a distribution properly chargeable to earnings and profits. Each approach then will be analyzed in light of existing expressions of legislative and judicial opinion. Finally, a suggestion as to the most appropriate formula for determining earnings and profits under section 312(e) will be offered.

THE THREE APPROACHES TO CALCULATING EARNINGS AND PROFITS UNDER SECTION 312(e)

Jarvis v. Commissioner

The initial decisions involving the predecessor to section 312(e) dealt with the effect of earnings and profits accumulated prior to March 1, 1913, the effective date of the Revenue Act of 1913. It was not until the 1941 Board of Tax Appeals decision in Jarvis v. Commissioner that the courts were called upon to determine the amount properly chargeable to capital in a situation uncolored by the presence of pre-1913 earnings and profits.

Jarvis arose in a relatively uncomplicated factual setting. The taxpayer contested a determination by the Commissioner that income received from distributions in 1935 was fully taxable as divi-
dends, claiming that a partial liquidation in 1934 had so reduced corporate earnings and profits as to render a part of the distributions a return of capital. The corporation, upon whose shares the distributions were made, had been organized in 1915 and had issued 10,000 shares of $100 par value common stock in that year, in exchange for securities having a value of $2,112,299. At the same time, it also assumed obligations of its sole shareholder totalling $200,800. In 1934, 1000 shares, 10 percent of those issued and outstanding, were redeemed for a total consideration of $1,160,000. In accounting for this transaction, the company had charged the par value of the redeemed shares, $100,000, to its capital account, and the remaining $1,060,000 paid out in the redemption to earnings and profits, thereby reducing its accumulated earnings and profits as of December 31, 1934 to $388,152.67. Between January 1 and May 14, 1935, the company's earnings and profits amounted to $206,589.79, while its ordinary distributions totaled $1,053,000. Jarvis contended that earnings and profits had been eliminated as of May 14, and that the $435,150 distributed during the remainder of 1935 was includable in gross income only to the extent of $349,183.56, the earnings and profits earned after May 14, 1935. The government argued that the proper manner to account for the 1934 redemption was to charge it in full to the capital account, without reducing earnings and profits until capital was exhausted. In the alternative, the government contended that the redemption price included unrealized appreciation of the corporation's assets, which, to the extent attributable to the redeemed shares, should not be charged to earnings and profits.

Rejecting both of the arguments advanced by the government, the Jarvis board found that "[the corporation] has but one 'capital

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22 43 B.T.A. at 443-44.
23 Id. at 440-44. An examination of contentions of the taxpayer in Jarvis reveals that the modern concept of prorating current earnings and profits over the distributions for the entire year and then applying the previously accumulated earnings and profits as available at the date of distribution, Treas. Reg. § 1.316-2(b), (c), had not yet been adopted. Under the present Regulations, the amount of dividend income to Jarvis would equal the same amount as that determined by the Board. If, however, the earnings and profits for the period from May 14 to December 31 had exceeded the distributions during that period, then the approach used in Jarvis would result in taxation of a smaller amount as dividends than the Regulations now permit. See Treas. Reg. § 1.316-2(b), (c) (1960).
24 See 43 B.T.A. at 444. The government based its argument on the Supreme Court's decision in Foster v. United States, 303 U.S. 118 (1938), discussed in notes 62-74 and accompanying text infra. See Edelstein & Korbel, The Impact of Redemption and Liquidation Distributions on Earnings and Profits: Tax Accounting Aberrations Under Section 312(e), 20 Tax. L. Rev. 479, 491-96 (1965) [hereinafter cited as Edelstein & Korbel].
25 See Edelstein & Korbel, supra note 24, at 497 n.75.
adjusting earnings and profits
account’ and that account consists of the original amount received for its capital stock, comprising both the par value and the paid-in surplus . . . .”28 The Board went on to determine that the proper charge to capital was 10 percent of the original consideration received for the stock, as 10 percent represented the percentage of shares involved in the redemption, while the balance of the distribution was chargeable to earnings and profits.27 Employing similar reasoning, the Court of Appeals for the Fourth Circuit affirmed the decision of the Board.28

Woodward Investment Company v. Commissioner

Within a year of the Jarvis decision the Board of Tax Appeals, in Woodward Investment Company v. Commissioner,29 was presented with another opportunity to determine the proper charge to earnings and profits in a partial liquidation situation. The precise issue in Woodward concerned the proper amount allowable to the corporation as a dividends paid credit under section 27(f) of the Revenue Act of 1936.30 Under this provision, a corporation was afforded a tax credit for a fraction of the amount distributed as dividends during the tax year.31 Included in those distributions qualifying for the credit was that part of a liquidation distribution “properly chargeable to earnings or profits.”32 The amount properly chargeable to earnings or profits was the amount of the distribution less the part “properly chargeable to capital account.”33 Thus, in disposing of the tax credit question, the Board had to make a 312(e)-like determination as to the proper charge to earnings and profits.

The Woodward company had made a liquidating distribution of property having a basis of $112,800,34 at a time when its earnings

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28 43 B.T.A. at 444 (citing Horrmann v. Commissioner, 34 B.T.A. 1178, 1186-87 (1936); Stifel v. Commissioner, 29 B.T.A. 1145, 1150 (1934)).
27 43 B.T.A. at 445.
26 Helvering v. Jarvis, 123 F.2d 742 (4th Cir. 1941).
29 46 B.T.A. 648 (1942).
31 See id. § 27(b).
32 Id. § 27(f).
33 Id. § 115(c), 49 Stat. 1687-88. Although a dividends-paid credit is not available under current law, corporations are now afforded a deduction for dividends paid, I.R.C. §§ 561-565, including the portion of a liquidating distribution properly chargeable to earnings and profits, in computing the accumulated earnings tax, id. § 535(a), and the personal holding company tax, id. § 545(a). Therefore, the law which developed under section 27(f) remains significant.
34 Revenue Act of 1936, Pub. L. No. 740, ch. 690, § 115(c), 49 Stat. 1687. Included in the definition of complete liquidation is “any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide
and profits equalled $218,223.95 and its total capital including earned surplus aggregated $445,661.27. In determining the amount of this distribution properly chargeable to earnings and profits, the Board fashioned a new approach, finding the Jarvis rule inapplicable where, as in the instant case, no shares have been redeemed. Pursuant to this new formula, the Board charged earnings and profits by that amount which bore the same ratio to the distribution as accumulated earnings and profits bore to total capital and surplus. The amount was determined as follows:

<table>
<thead>
<tr>
<th>Accumulated Earnings and Profits</th>
<th>Total Capital and Surplus</th>
<th>Amount of Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>($218,233.95)</td>
<td>($445,661.27)</td>
<td>($112,800)</td>
</tr>
</tbody>
</table>

Revenue Ruling 70-531

Shortly after Woodward, the government abandoned the position that a distribution in redemption or partial liquidation should be charged fully to capital without any reduction in earnings and profits until capital has been exhausted. At the same time, the Internal Revenue Service acquiesced in the Jarvis and Woodward decisions stating that the two cases "are not inconsistent, . . . [but] merely reflect necessary differences in the application of a general principle to different . . . situations."

The Service plan of liquidation . . . . "Id. Such a distribution would now be embraced within the definition of partial liquidation. See I.R.C. § 346(a)(1).

\[46\] B.T.A. at 649. The total capital and earned surplus was derived as follows:

- Capital Stock $150,000.00
- Paid-In Surplus 21,000.00
- Pre-1913 Earned Surplus 6,563.25
- Appreciation at March, 1, 1913, realized in later years 49,874.07
- Post-1913 Earned Surplus
- Total $218,223.95

\[47\] Id. at 650. The Board dismissed the Commissioner's contention, finding no relationship between the credit and the existence or nonexistence of taxable gain to the shareholder. \[48\] Id. at 651.

\[49\] The sole shareholder of the Woodward Company had a cost basis in her shares of $424,300. Since her basis exceeded the amount of the 1936 distribution, the distribution was treated as a return of capital and the shareholder realized no gain as a result of it. \[50\] Id. Based on this fact, the Commissioner argued that it was inappropriate to permit the corporation a dividends-paid credit. \[51\] Id. at 650. The Board dismissed the Commissioner's contention, finding no relationship between the credit and the existence or nonexistence of taxable gain to the shareholder. \[52\] Id. at 651.

\[53\] Id. at 652.

\[54\] See G.C.M. 23460, 1942-2 C.B. 190.


abruptly reversed itself again some years later in Revenue Ruling 70-531, withdrawing its previous acquiescence to Jarvis and Woodward and establishing a new formula for determining the proper charge to earnings and profits. Apparently designed to eliminate any charge to earnings and profits resulting from unrealized appreciation, the Revenue Ruling provided that any difference between the amount distributed and the ratable share of both the paid-in capital and the earnings and profits—i.e., unrealized appreciation and other "similar attributes"—should be included in the capital account. Reasoning from this definition of capital account, the Revenue Ruling concluded that the proper charge to earnings and profits is the amount of the earnings and profits ratably attributable to the shares redeemed, regardless of the amount of the distribution or the amount of paid-in capital.

Somewhat unclear is the intent of the Internal Revenue Service in withdrawing its acquiescence to Woodward and substituting in

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\[ X = D - C \]

Since:

\[ C = P + [D - (P + E)], \quad \text{or} \quad C = D - E \]

Then substituting for C:

\[ X = D - D + E, \quad \text{or} \quad X = E. \]

Thus, the proper charge to earnings and profits under the Revenue Ruling is the amount of the earnings and profits ratably attributable to the shares redeemed.
its stead an "acquiescence in result only." The term acquiescence in result only has been defined as "acceptance of the decision of the Court but disagreement with some or all of the reasons assigned for the decision." Since the capital account concept employed by the Woodward Board did not include any unrealized appreciation, the Service by its action seems to have opted for a rather curious position; while requiring inclusion of unrealized appreciation in the capital account where an actual redemption occurs, the Service did not object to the Woodward Board's failure to make this inclusion where the distribution was made ratably to all outstanding shares.

A Summary of the Three Approaches

The interrelationship of and differences among the three approaches can best be illustrated by example. Therefore, the following hypothetical facts will be referred to throughout the remainder of this Note:

Corporation X has two shareholders, A and B, each of whom own 10 shares of $2 par value common stock. The records of X reveal the following:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets (basis)</td>
<td>$100</td>
</tr>
<tr>
<td>Liabilities</td>
<td>0</td>
</tr>
<tr>
<td>Earnings and Profits</td>
<td>$60</td>
</tr>
<tr>
<td>Stated Capital (20 shares at $2 par)</td>
<td>$40</td>
</tr>
<tr>
<td>Paid-In Surplus</td>
<td>0</td>
</tr>
</tbody>
</table>

X's assets have increased in value to $200, indicating unrealized appreciation of $100. X will redeem 5 of A's shares for what A believes to be their value, $50, one-fourth of the value of the assets of X.

Under Jarvis, the capital account equals $40. As 25 percent of X's stock is being redeemed, the charge to capital is 25 percent of $40, or $10. The balance of the distribution, $40, is charged to earnings and profits, reducing that account to $20. The Woodward formula also operates upon a capital account of $40. Earnings and profits would be reduced by an amount which bears the same ratio to the total distribution, $50, as earnings and profits, $60, bears to the sum of earnings and profits and paid-in capital, $60 + $40.

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47 Id. at xxii n.4.
48 See note 35 supra.
49 See notes 78-82 and accompanying text infra.
Thus, the charge to earnings and profits would be computed as follows:

\[
50 \times \frac{60}{100} = 30
\]

The balance in the earnings and profits account would be $30. The Revenue Ruling would charge earnings and profits by that portion of total earnings and profits, $60, attributable to the shares redeemed. As one-fourth of X's shares are being redeemed, application of the Ruling would reduce earnings and profits by one-fourth, or $15, leaving a balance in that account of $45.

**Legislative Intent**

It is no easy task to discern the intent of Congress in enacting the original version of section 312(e) or in leaving the section substantially unaltered despite the many tax reform measures which have ensued. The original language of section 201(c) of the Revenue Act of 1924 makes manifest, however, that the primary concern of Congress was "the taxability of subsequent distributions." Although this language was deleted in 1936, there is no reason to presume that the taxability consideration no longer was deemed relevant.

In the House and Senate committee reports on the Revenue Act of 1924, reference was made to the language of section 201(c) excluding from the charge to earnings and profits the amount properly chargeable to capital: "[T]he provisions . . . represent what is probably the correct construction of the existing law and unquestionably what is in accord with business practice." Although this language would seem to indicate only that some charge to capital was in accord with then existing business practice, a few commentators have unsuccessfully attempted to identify the amount of the charge under accounting practices existing in 1924, inferring from the committee reports that Congress meant to adopt that method.

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51 See Revenue Act of 1936, Pub. L. No. 740, ch. 690, § 115(c), 49 Stat. 1687. It has been suggested that the language was deleted due to the relationship between the dividends-paid credit and the charge to earnings and profits. See Edelstein & Korbel, supra note 24, at 482 n.11.
of computation. Similarly, attempts by these authorities to apply present accounting principles to section 312(e) have produced conflicting results.

The House and Senate reports accompanying the 1924 Act also contained an example demonstrating that a redemption of stock at its par value "does not affect earnings and profits of the corporation on hand for subsequent distribution." Under both the Woodward and Revenue Ruling formulas, however, a redemption at par would call for some reduction in earnings and profits. This result can be demonstrated by employing the hypothetical facts previously set forth, with one minor alteration: five of A's shares are now being redeemed for their aggregate par value, $10. Woodward would compute the charge to earnings and profits as follows:

$$10 \times \frac{60}{100} = 6$$

The balance of the distribution, $4, would be charged to capital. The approach set forth by Revenue Ruling 70-531 would reduce earnings and profits by that portion of earnings and profits attributable to the shares redeemed, which equals $15. Since the charge exceeds the amount distributed, there is no reduction of capital account. It is only under Jarvis that the result suggested by the congressional reports is obtained, i.e., capital is reduced by par and there is no reduction in earnings and profits.

As the authority of these early expressions of congressional intent may be discounted due to the novelty of the earnings and profits concept as well as the general lack of expertise with income tax legislation, an examination of the case law in the area should prove helpful. The initial court decisions construing the predecessors to section 312(e) were concerned with the treatment of pre-1913 earnings and profits. Relying in great part on the language added to the Code by the Revenue Act of 1918, which provided that "[a]ny distribution . . . shall be deemed to have been made from

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55 See, e.g., Edelstein & Korbel, supra note 24, at 487-88.
58 See, e.g., Helvering v. Craig, 1937 B.T.A.M. (P-H) ¶ 114, remanded mem., 97 F.2d 1004 (8th Cir. 1938); Horrmann v. Commissioner, 34 B.T.A. 1178 (1938); Stewart v. Commissioner, 29 B.T.A. 809 (1934).
earnings or profits accumulated since February 28, 1913 . . . ," 60 these cases had held that the distribution should first be charged against the portion of the paid-in capital standing behind the shares redeemed, and the entire balance of the distribution should then be charged to post-1913 earnings and profits. Only after the latter account was exhausted would the remainder of the distribution be charged to pre-1913 earnings and profits. 61

The Supreme Court rejected this view in Foster v. United States, 62 holding that the capital account included both pre-1913 earnings and profits and appreciation. The corporation in Foster had distributed $1,025,000 in redemption of one-fourth of its outstanding capital stock. The paid-in capital of the corporation totaled $200,000, its pre-1913 earnings and profits plus appreciation as of March 1, 1913 were in excess of $3,725,000, and its post-1913 earnings and profits equaled $330,578.98. 63 The taxpayer contended that the distribution was chargeable to paid-in capital to the extent of the par value of the shares redeemed, $50,000, and then to post-1913 earnings and profits, thereby eliminating that account. 64 The basis for this contention was section 115(b) of the Revenue Act of 1928, 65 which stated that "all distributions are paid from 'the most recently accumulated earnings or profits.'" 66

The Court rejected the taxpayer's argument, finding that the clear intent underlying section 115(b) was to ensure "that pre-1913 accumulations . . . not be distributed 'in such a fashion as to permit profits accumulated after that date to escape taxation,'" 67 and that to construe the section as the petitioner requested "would facilitate the escape of such profits from taxation and thereby defeat the undoubted purpose of Congress." 68 Noting further that "[w]e must not give effect to any contrivance which would defeat a tax Congress plainly intended to impose . . . [and that] bookkeeping terms and accounting forms and devices cannot be permitted to devitalize valid tax laws," 69 the Foster Court held there should be no reduction

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61 See cases cited in note 58 supra.
62 303 U.S. 118 (1938).
63 Id. at 119.
64 Id.
67 303 U.S. at 120 (quoting Helvering v. Canfield, 291 U.S. 163, 168 (1934)).
68 303 U.S. at 120.
69 Id. at 121.
in post-1913 accumulations, and that pre-1913 earnings and profits were includable in the capital account. 70

The importance of Foster lies not in its holding that the capital account includes pre-1913 earnings and profits, nor in the Court's decision not to reduce earnings and profits until the full amount of capital attributable to the redeemed shares had been eliminated. Rather, the major significance of the case lies in the Court's finding that the legislative intent behind the dividend and earnings and profits provisions of the Code was to prohibit the use of redemption distributions as a device to reduce the post-1913 earnings and profits account and thereby permit subsequent distributions to be made tax-free.

In articulating the facts, the Foster Court noted that paid-in capital was $200,000, the amount of the distribution was $1,025,000, and the pre-1913 earnings and profits were in excess of $3,725,000. The extent of this excess was not indicated. If the capital account, including pre-1913 earnings and profits, is reduced by one-fourth (the percentage of the capital stock redeemed), there remains $43,750 of the distribution to be charged to some account. Yet the Court failed to reduce post-1913 earnings and profits by any amount. It would seem, therefore, that the Court believed pre-1913 earnings and profits were substantially greater than $3,725,000, or that the Court was charging the capital account in full and not pro rata to the shares redeemed. 71 This aspect of the Foster decision formed the basis of the government's contention in Jarvis that the distribution in its entirety should be charged against capital. In rejecting this position, the Board of Tax Appeals in Jarvis found that Foster was limited to situations in which pre-1913 earnings and profits existed, 72 stating: "The present case involves no opportunity to escape a tax by a bookkeeping device." 73 As previously illustrated, however, the formula applied by the Jarvis Board allows unrealized appreciation to reduce the earnings and profits account, thus permitting subsequent distributions to be made tax free. This clearly results in an escape from taxation. Furthermore, the Board's reading of Foster is questionable; the language of Foster was not limited in any manner to situations involving pre-1913 earnings and profits. The Foster Court emphasized that "[w]e must not give effect to any contrivance which would defeat a tax Congress plainly

70 Id. at 122.
71 See Edelstein & Korbel, supra note 24, at 494.
72 43 B.T.A. at 444.
73 Id.
intended to impose," indicating that items which would have been taxable before the distribution should be taxable thereafter.

IMPLEMENTING THE INTENT OF CONGRESS

It is suggested that in implementing congressional intent as expounded in the Foster decision, taxing authorities should pay heed to the tax burden of the shareholders remaining after a distribution in redemption or partial liquidation. If properly utilized, section 312(e) should prevent tax avoidance while providing equitable treatment for the remaining shareholders. Particular attention should be focused upon the possibility of subsequent ordinary distributions being taxed as dividends where, had there been no redemption or partial liquidation, such distributions would have been treated as a return of capital to the shareholder. For instance, if corporation X in the hypothetical facts were not permitted to reduce earnings and profits upon the redemption of five of A's shares, upon a subsequent ordinary distribution of $4 per outstanding share B would be treated as having received $40 in dividend income. Had there been an ordinary distribution of $4 per share without a prior redemption since X had only $60 of earnings and profits and distributed $80 to A and B, only $30 of the $40 received by B would be a dividend. The remaining $10 distributed would either reduce B's basis in his shares or be taxed as a gain from the sale or exchange of a capital asset. Thus, to put B in the same position in which he would have been in the absence of a redemption, the balance of the earnings and profits account must be $45, which would create dividend income only to the extent of $3 per outstanding share. This precise result would be reached under the formula prescribed by Revenue Ruling 70-531.

Application of the Revenue Ruling in a situation involving unrealized appreciation, however, leads to only an approximation of the desired result. In the hypothetical facts, if X realizes $12 of previously unrealized appreciation subsequent to the redemption, its earnings and profits will be increased by the same amount. Had there been no redemption, X's earnings and profits would be $72 ($60 + $12), and on a $4 per share ordinary distribution, $3.60 would be taxed as a dividend. To obtain this same result after a redemption of five shares, X's earnings and profits would have to equal $54. As computed previously, the Revenue Ruling produces a balance in

\[303\text{ U.S. at 121 (emphasis added).}\]
the earnings and profits account of $45 immediately after the distribution, which increases to $57 upon realization of the $12 appreciation. As a result, the remaining shareholders will bear a heavier tax burden than they would have in the absence of the redemption. The $3 difference between the desired result ($54) and the result actually obtained under the Ruling may be traced to the portion of the now realized appreciation attributable to the shares redeemed (one-fourth of $12). Thus, to ensure equitable treatment of the remaining shareholders, items of appreciation unrealized at the time of the redemption should be identified and, upon their subsequent realization, the portions attributable to the shares redeemed should be excluded from the increase to earnings and profits. As a practical matter, however, attributing unrealized appreciation to specific pieces of property upon each redemption and carrying this information in a corporation's records until realization would be an almost impossible task.

Recognizing the impracticality of such an approach, commentators have suggested a more feasible alternative which would satisfy the goal of equitably taxing outstanding shares. This alternative would establish an earnings and profits deferral account consisting of any difference between the amount distributed and the book value (the pro rata share of paid-in capital plus earnings and profits) of the shares redeemed. Each year following the redemption, a percentage of the current earnings and profits would be applied against the deferral account until the latter was exhausted. The percentage utilized in this calculation would equal the percentage of stock that had been redeemed. Using the hypothetical facts as an illustration, upon a redemption of one-fourth of X's outstanding shares for $50, $25 (the amount of the distribution exceeding book value) would be placed in a new deferral account. If X has $12 of current earnings and profits the following year, one-fourth of that amount, $3, would be applied against the deferral account, which would be reduced to $22. The $9 balance of current earnings and profits, in accordance with normal procedures, would be applied to the earnings and profits account. This process would be repeated annually until the balance in the deferral account was fully depleted.

Where shares are redeemed at less than book value, the Reve-

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nue Ruling formula produces an equitable result, while the Jarvis and Woodward standards penalize the remaining shareholders. Consider, for instance, the result when $X$ redeems one-half of $A$'s shares for $16, $9 below the book value. Jarvis charges capital $10 and earnings and profits by the balance of the distribution, $6. This leaves a balance in the earnings and profits account of $54. Had there been no redemption, $B$ would have incurred taxable dividend income on only the first $30 of ordinary distributions. Following the redemption, under the Jarvis approach, the first $36 of subsequent ordinary distributions is taxed as dividends to $B$. Similarly, under Woodward, the charge to earnings and profits is:

\[
\frac{16 \times 60}{100} = 9.60
\]

The balance in the earnings and profits account is $50.40. Consequently, $B$ will realize dividend income on the first $33.60 subsequent distributed, while in the absence of the redemption he would have been so taxed on only the first $30.

The Revenue Ruling approach, with the modification suggested, thus is readily applicable to redemptions or partial liquidations in which shares are surrendered. The approach of Revenue Ruling 70-531 presents difficulties when the corporation exchanges appreciated property for shares. I.R.C. § 311(d)(1) provides that gain will be recognized to the distributing corporation to the extent of the excess of the fair market value of the distributed property over its adjusted basis. Where gain is recognized, the current year's earnings and profits are increased, and consequently, the charge to earnings and profits under the Revenue Ruling is greater. See Rev. Rul. 70-531, 1970-2 C.B. 76. After such a redemption, the remaining shareholder's portion of the earnings and profits increases due to the realization of the appreciation. This result, however, is in accord with Congress's intent to treat the distribution of appreciated property in a redemption as a true realization event. The result, at least with respect to noncorporate shareholders, is the same as that reached in the situation where the corporation has sold the property and distributed the proceeds.

Where the redemption with appreciated property falls into one of the exceptions of § 311(d)(2), resulting in no gain to the distributing corporation, a modified deferral approach, see note 75 and accompanying text supra, seems necessary.

76 The approach of Revenue Ruling 70-531 presents difficulties when the corporation exchanges appreciated property for shares. I.R.C. § 311(d)(1) provides that gain will be recognized to the distributing corporation to the extent of the excess of the fair market value of the distributed property over its adjusted basis. Where gain is recognized, the current year's earnings and profits are increased, and consequently, the charge to earnings and profits under the Revenue Ruling is greater. See Rev. Rul. 70-531, 1970-2 C.B. 76. After such a redemption, the remaining shareholder's portion of the earnings and profits increases due to the realization of the appreciation. This result, however, is in accord with Congress's intent to treat the distribution of appreciated property in a redemption as a true realization event. The result, at least with respect to noncorporate shareholders, is the same as that reached in the situation where the corporation has sold the property and distributed the proceeds.

77 See I.R.C. §§ 331, 346.
puted using the basis to the corporation of the property distributed, it would seem reasonable to premise the amount of the charge upon the percentage, in terms of basis, of the assets distributed. For example, if one-fourth of the corporate assets are distributed in partial liquidation, earnings and profits should be reduced by the same proportion. Under this approach, the result obtained is approximately the same as that produced by Woodward. By reducing earnings and profits by that portion of the amount distributed which bears the same ratio to the total distribution as earnings and profits bears to the sum of earnings and profits plus paid-in capital, the Woodward Board implicitly recognized that the sum of earnings and profits plus paid-in capital will equal the total net basis of the assets of the corporation. Although it may deviate somewhat, such sum does tend to approximate net assets. Perhaps this accounts for the Internal Revenue Service's withdrawal of its general acquiescence to Woodward and substitution of an acquiescence in result only.

The above suggestion concerning the proper treatment of pro rata distributions in partial liquidation was contained in the House version of the Revenue Act of 1954 as a proposed amendment to the predecessor of section 312(e). This amendment directed a reduction in earnings and profits proportionate to the reduction in the net assets of the corporation on a distribution in redemption or partial liquidation. The proposal was rejected by the Senate, which found

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78 Id. § 312(a)(3).
79 This formulation was proposed by the House in 1954 as a revision to § 312(e). See notes 83-85 and accompanying text infra.
80 Cf. Edelstein & Korbel, supra note 24, at 505-06. But see Winds of Change, supra note 75, at 653, wherein the author cautioned that reliance on the balance sheet earned surplus account, which when added to the financial capital account equals the net assets, as an indicator of earnings and profits may be unwise. As the author suggested, the concept of capital for balance sheet purposes may differ greatly from the notion of capital employed for 312(e) calculations.
81 It is generally conceded that capital includes the amount paid-in for the stock issued, plus any pre-1913 appreciation in the value of the assets of the corporation and pre-1913 earnings and profits. Treas. Reg. § 1.562-1(b)(1)(ii) (1960). Differing interpretations of the phrase "amount paid-in" have been suggested, ranging from the par or stated value of the stock plus surplus to the corporation's basis in the assets contributed. Compare Treas. Reg. § 1.562-1(b)(1)(ii) (1960), with Edelstein & Korbel, supra note 24, at 510-12.
82 Since I.R.C. § 312(k) limits the charge to earnings and profits for depreciation to the amount computed under the straight line method, the sum of earnings and profits plus paid-in capital will not equal the total net basis of the assets of the corporation if the corporation uses the declining balance method of depreciation.
83 See notes 46-49 and accompanying text supra.
"that existing administrative practice, making these determinations as the facts of each case may indicate, has been successful in achieving correct results." As of 1954, however, existing administrative practice recognized two approaches: the Jarvis approach where shares were redeemed or surrendered, and the Woodward approach where the number of shares outstanding did not change. The Senate language with respect to a case-by-case determination therefore seems to indicate a lack of awareness of the existing administrative practice. Furthermore, the correctness of the results achieved under Jarvis and Woodward is open to serious question.

Recent Developments

The Tax Court, in Anderson v. Commissioner, was recently presented with a situation calling for a choice between the approaches of Jarvis and Revenue Ruling 70-531. The case involved a section 302(a) redemption wherein the distributing corporation used par value plus the pro rata portion of paid-in surplus attributable to the shares redeemed as the amount properly chargeable to capital account. The balance of the distribution was charged in full to earnings and profits. Consequently, on a redemption of 17 percent of the common stock, earnings and profits were reduced from $1,487,182 to $990,241, a reduction of 33 percent. One and one-half years later the corporation redeemed all 1710 shares of its $100 par preferred stock, which had no paid-in surplus, for $411,733. The
excess of the distribution over the aggregate par value of the shares redeemed was charged to earnings and profits. In upholding these charges and rejecting the Revenue Ruling, the court employed a two-part rationale. Observing that under Revenue Ruling 70-531 the charge to earnings and profits is computed first without reference to capital account, after which the charge to the capital account is determined, the *Anderson* court found that the language of the statute requires the charge to capital account to be computed first, with the balance of the distribution being charged to earnings and profits. In addition, the Tax Court concluded that the Senate's rejection of the proposed amendment to 312(e) in 1954 indicated legislative approval of the *Jarvis* approach.

It is suggested that the *Anderson* court's decision is highly questionable. Section 312(e) as originally enacted provided: "In the case of amounts distributed in partial liquidation . . . the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits . . . ." Strictly construed, this language leaves doubt as to whether the charge to capital must be computed before the charge to earnings and profits. The statute does clearly establish that some portion of a distribution may be chargeable to capital rather than earnings and profits. In view of these factors, it would seem that the Revenue Ruling is not inconsistent with the statutory language.

**CONCLUSION**

The most significant interpretation of section 312(e) voiced to
date is the Supreme Court's concise statement in Foster v. United States: "We must not give effect to any contrivance which would defeat a tax [the tax on dividends] Congress plainly intended to impose." It is submitted that Revenue Ruling 70-531, as modified by the use of a deferral account, accomplishes the Foster objective in the redemption situation, prohibiting the tax-free distribution of earnings and profits normally taxable as dividends. By its own terms, however, the Ruling is inapplicable in the case of a distribution in partial liquidation where no shares are surrendered; in such a situation, it defers to the result reached in Woodward, which approximates the desired result.

While the Tax Court in Anderson conceded that the Internal Revenue Service interpretation yields an equitable result, the court unfortunately failed to implement that formula. Even though it thus will not be given effect by the Tax Court, the Ruling seems to fall well within the broad parameters of section 312(e). Moreover, no definitive expression of Congress appears to preclude the application of this approach. Presented with a proper factual situation,

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303 U.S. 118 (1938), discussed in notes 62-74 and accompanying text supra.
303 U.S. at 121.
See text accompanying note 75 supra.
See notes 46-49 and accompanying text supra.
See notes 78-82 and accompanying text supra.
67 T.C. at 541 n.27.

Three major arguments against the Revenue Ruling formula have surfaced. These arguments, all premised to some extent upon legislative intent, are that Revenue Ruling 70-531 renders the term capital account meaningless, see note 90 and accompanying text supra, that the wording of section 312(e) requires the charge to capital account to be computed before the charge to earnings and profits, see notes 91-93 and accompanying text supra, and that in enacting the Revenue Act of 1954 the Senate rejected a proposed amendment to section 312(e), finding "that existing administrative practice . . . has been successful in achieving correct results." S. REP. No. 1622, 83d Cong., 2d Sess. 47, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4678, discussed at notes 83-85 and accompanying text supra.

One authority has based an argument upon the Revenue Act of 1962, Pub. L. No. 87-834, 87th Cong., 2d Sess., which added what is now I.R.C. § 312(j)(3):

If a foreign investment company . . . distributes amounts in partial liquidation or in a redemption to which section 302(a) or 303 applies, the part of such distribution which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable share of the earnings and profits of the company accumulated after February 28, 1913, attributable to the stock so redeemed.

I.R.C. § 312(j)(3). According to this commentator, since Congress specifically amended the provisions with respect to foreign investment companies, yet left section 312(e) unchanged, it "reiterated, at least sub silentio, its acceptance of the then existing rules for the application of section 312(e)." Edelstein, Revenue Ruling 70-531: Section 312(e) Revisited, 26 TAX L. Rsv. 855, 859 (1971). In response to this contention, it may be argued that because Congress was primarily concerned with the provisions involving foreign-related income, see McCoy, Revenue Ruling 70-531: Another View, 26 TAX L. Rsv. 864, 871 (1971), it could not reasonably
an appellate court favorably inclined toward protecting tax revenue could and should adopt Revenue Ruling 70-531.

Mark L. Regante

have been expected to amend section 312(e) at that time. Furthermore, section 312(j)(3) may merely represent "a congressional desire to avoid the uncertainty and inequity of the various precedents under section 312(e)." Id. at 870.