"DIVIDENDS" AND "EARNINGS OR PROFITS" UNDER THE INCOME TAX LAW: CORPORATE NON- LIQUIDATING DISTRIBUTIONS

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I. INTRODUCTION

American corporations annually distribute billions of dollars¹ in dividends.² The average individual stockholder participating in this largesse pockets his dividend with the assumption that the federal income tax authorities will demand their share. Ordinarily, he is not disappointed, but in a large number of cases³ the stockholder will learn, often to his surprise, that part or even all of the dividend received by him has been ruled by the Commissioner of Internal Revenue to be a return of capital and hence non-taxable.⁴ If the stockholder asks for an explanation of why the dividend is not a "dividend," he is generally told that it represents, in whole or in part, a return of capital, or that it represents a distribution out of earnings or profits accumulated before March 1, 1913,⁵ and that under the law, distributions out of such a

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1. For 1938, dividends paid by industrial corporations (other than stock dividends) amounted to approximately \$5,000,000,000. Statistics of Income for 1938, Treasury Department Press Release, February 26, 1941.

2. Throughout this article the term "dividend" will be enclosed in quotation marks wherever it is used in the technical sense of the income tax law. Where not so enclosed, the term is to be given its commonly accepted meaning.

3. Prentice-Hall, Inc. and Sinclair, Murray & Co., Inc., both of New York, publish lists of publicly owned companies whose dividends are ruled to be partly or entirely non-taxable.

4. This boon is not entirely without price. The exempt portion of the dividend must be applied in reduction of the stockholder's basis for his stock, and if in excess of that basis, such excess must be treated as gain from the sale or exchange of property (except that, with respect to a distribution out of increase in value of property accrued before March 1, 1913, the excess is not taxable at all). *INT. REV. CODE*, § 115 (b) and (d). See p. 871 *infra*. This is generally a comparatively small price for the reason that any taxable excess over basis, and the increase in gain that will result on a sale of the stock because of the reduction in basis, will ordinarily be taxable to individual stockholders at the advantageous rates prescribed for long-term capital gains. *INT. REV. CODE* § 117 (b) and (c). Where the stockholder is an individual (or a partnership, estate or trust), he will nearly always be glad to learn that a particular distribution is not technically a "dividend" (whether in whole or in part); but where the stockholder is another corporation, the situation will be reversed. Eighty-five per cent of "dividends" received by one corporation from another domestic corporation are, in effect, exempt from normal tax. *INT. REV. CODE* § 26 (b). Hence, only 15% of a "dividend" received by a corporation is taxable. Gains from the sale or exchange of property, on the other hand, are fully taxable to a corporation; so that a receiving corporation would prefer to have the dividend treated as a "dividend" and to leave the basis for its investment unaffected.

5. This was the effective date of the first income tax law after the adoption of the Sixteenth Amendment.

source are not "dividends." Whether or not this explanation satisfies him, he will have learned that what the distributing corporation may call a dividend, or what the state law may call a dividend,⁶ or even what the recipient thinks of without question as a dividend, is not necessarily a "dividend" for federal income tax purposes.⁷ The reasons for the distinction are found, first, in the fact that the income tax law, not content to rest on the common conception of a dividend, sets up its own definition,⁸ and, second, in certain statutory presumptions as to the source of a corporate distribution. Moreover, one of the terms contained in the statutory definition, i. e., "earnings or profits," has never been given precise definition and has been, up to now, a center of controversy. This paper will consider, in order, these three sources of difficulty: the statutory definition of a "dividend," the effect of the statutory presumptions as to the source of a distribution, and the meaning of the term "earnings or profits."

II. THE STATUTORY DEFINITION OF A "DIVIDEND"

The first income tax law enacted after the Sixteenth Amendment to the Constitution, i. e., the 1913 law, contained no definition of the term "dividend." It merely provided that gross income included "dividends."⁹ The Treasury Department ascribed to the word its commonly accepted import and sought to tax all corporate distributions chargeable against corporate surplus. This position was challenged in a series of cases, only one of which, *Lynch v. Hornby*,¹⁰ is of particular significance in this discussion. Hornby was a stockholder in a lumber corporation which in 1914 declared and paid a dividend. Hornby conceded that he was taxable on that proportion of the dividend which represented a distribution of current earnings, but he maintained that so much of the dividend as was paid out of earnings accumulated prior to March 1, 1913 (the effective date of the 1913 income tax law), was a return of capital which was not taxable under the 1913

6. In general, the legality of a dividend declaration under state law has no bearing on the question of its status for income tax purposes.

7. As indicated by its sub-title, this article is concerned only with non-liquidating distributions, except in so far as a liquidating distribution may affect the source of a later non-liquidating distribution. For a discussion of liquidating distributions see Darrell, *Corporate Liquidations and the Federal Income Tax* (1941) 89 U. OF PA. L. REV. 907, *infra* in this issue.

8. INT. REV. CODE § 115 (a).

9. Revenue Act of Oct. 3, 1913, § II B. (The cognate provision of the present law is § 22 (a) of the Internal Revenue Code.)

10. 247 U. S. 339 (1918). The other cases were: *Gulf Oil Corp. v. Lewellyn*, 248 U. S. 71 (1918); *Lynch v. Turrish*, 247 U. S. 221 (1918); *Southern Pacific Co. v. Lowe*, 247 U. S. 330 (1918); *Peabody v. Eisner*, 247 U. S. 347 (1918). These cases are criticized, not so much for their results as for their reasoning, by Professor Powell, *Income from Corporate Dividends* (1922) 35 HARV. L. REV. 363.

law and could not be constitutionally taxed without apportionment according to population.¹¹

The lower courts had sustained Hornby,¹² but the Supreme Court rejected his argument and held that Congress could validly tax distributions out of earnings accumulated prior to 1913 and had done so in the 1913 law. The Court stated that

"Congress was at liberty under the [Sixteenth] Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing. Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based on the increased value of the property of the corporation. The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand." ¹³

Unfortunately, the Court did not have an opportunity to express these views until June 3, 1918. Congress had, in the meantime, in the Act of September 8, 1916, added a proviso to the definition of gross income which for the first time defined the term "dividends." The pertinent part of this definition read:

". . . the term 'dividends' . . . shall be held to mean any distribution made . . . by a corporation . . . out of its earnings or profits accrued since March 1, 1913, and payable to its shareholders" ¹⁴

In enacting this definition, the legislature was apparently influenced by the constitutional qualms engendered by the decisions of the lower

11. U. S. CONST. Art. 1, §§ 2, 9.

12. 236 Fed. 661 (C. C. A. 8th, 1916). The Circuit Court of Appeals decided the question as one of the statutory construction rather than on constitutional grounds. In the Supreme Court, the *Hornby* case was argued together with the *Turkish* case and the constitutional point was apparently only pressed in the *Turkish* case. However, the Supreme Court's opinion indicates that the Court considered the constitutional question implicit in the *Hornby* case also.

13. 247 U. S. 339, 344 (1918).

14. Revenue Act of Sept. 8, 1916, § 2 (a). The remainder of the definition provided that stock dividends should be subject to tax. This portion of the definition was held invalid in the famous 5-4 decision in *Eisner v. Macomber*, 252 U. S. 189 (1920). See p. 898 *infra*.

courts in the *Hornby* case.¹⁵ Had the constitutional spectre been laid to rest prior to the enactment of the 1916 law, it is quite conceivable that the barrier against the taxation of dividends out of pre-1913 earnings would never have been erected; in which case much litigation and some of the confusion surrounding the determination of the status of a corporate distribution would have been eliminated. Moreover, the revenue of the Federal Government would have been materially increased. Three times since 1916, the House of Representatives has repented of its misbegotten generosity only to be cheated of its repentance by an incorrigible Senate.¹⁶

From 1916 to 1936, a period of twenty years, the definition of a "dividend," except for certain provisions relating only to personal service corporations, remained virtually unchanged. The advent of the much maligned undistributed profits surtax in 1936 was responsible for the first expansion of the definition. This surtax was imposed on such part of the corporation's adjusted net income as was not distributed in the form of "dividends." Under the theretofore existing definition of a "dividend," a corporation with an earnings deficit at the beginning of the year would perforce be unable to distribute a "dividend" equal to its net income for the taxable year, for the reason that the deficit would have to be made good before there could be any accumulation of earnings or profits,¹⁷ and a "dividend" could be paid only if there were earnings or profits accumulated after February 28, 1913. Accordingly, in order to afford a measure of relief to corporations with deficits at the beginning of the year, by enabling them to obtain the benefit of the credit for "dividends" paid in computing the undistributed profits surtax, the definition of a "dividend" was amended to include distributions "out of the earnings or profits of the current taxable year (computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year) without regard to the amount of the earnings or profits at

15. *Lynch v. Hornby*, 247 U. S. 339, 346 (1918); *Edwards v. Douglass*, 269 U. S. 204, 211-212 (1925). In the *Hornby* opinion, Mr. Justice Pitney speaks of the 1916 provision as "a concession to the equity of stockholders granted . . . in view of constitutional questions that had been raised in this case, in the companion case of *Lynch v. Turrish*, and perhaps in other cases." The *Hornby* case was decided by the District Court in Jan. 1916; and by the Circuit Court of Appeals on Sept. 4, 1916.

16. *Report of Ways and Means Committee on 1928 Act*, 70th Cong., 1st Sess. (1928) 20; *Report of Conference Committee on 1932 Act*, 72d Cong., 1st Sess. (1932) 15; *Report of Ways and Means Committee on 1934 Act*, 73d Cong., 2d Sess. (1934) 15. The corresponding Senate Committee reports rejecting the House's proposal were as follows: 1928 Act, SEN. REP. No. 960, 70th Cong., 1st Sess. (1928) 12; 1932 Act, SEN. REP. No. 665, 72d Cong., 1st Sess. (1932) 30-31; 1934 Act, SEN. REP. No. 558, 73d Cong., 2d Sess. (1934) 36. There appears to be a common but mistaken notion that Congress first exempted pre-1913 earnings after the Supreme Court had told it they could be validly taxed.

17. See p. 873 *infra*.

the time the distribution was made."¹⁸ The language beginning with the parenthetical clause was added in order to avoid the difficult problems that would be involved in a determination of the current year's earnings up to the date of distribution.¹⁹

The undistributed profits surtax was put to a lingering death by the 1938 Act and ceased to be effective as to taxable years beginning in 1940; but the 1936 amendment to the "dividend" definition was permitted to remain in the law. As a consequence, the 1936 amendment is largely an anachronism²⁰ as to all corporations except such as are subject to tax by reason of not distributing their adjusted net income.²¹

The definition has not been altered since 1936. In the light of the current provision, the distribution of a "dividend" can only be effected if the corporation has either earnings or profits of the taxable year, i. e., the corporation's taxable year,²² or earnings or profits, accumulated since February 28, 1913, of past taxable years. Because of the statutory presumptions next to be considered, if the corporation's earnings or profits for the taxable year equalled or exceeded the amount of the distributions during the year it is unnecessary to inquire into the existence of past years' earnings.²³

III. THE SOURCE OF DISTRIBUTION

As indicated above, any distribution which would be commonly denominated a dividend was taxable until Congress undertook in 1916

18. *Report of Senate Finance Committee*, SEN. REP. NO. 2156, 74th Cong., 2d Sess. (1936) 18. The amendment failed to give relief, as had been proposed in the House bill (*Ways and Means Subcommittee report*, March 26, 1936), to corporations which had taxable net income but no earnings or profits of either the current year or past years. (As will hereinafter be shown, taxable net income and earnings or profits are not the same thing and it is possible to have one without the other.) Moreover, the amendment failed to give relief to corporations which were forbidden by state law from paying dividends. *Helvering v. Northwest Rolling Mills*, 311 U. S. 46 (1941). The consent dividend provisions of § 28, although intended as a relief measure, have been sparingly used because of their complexity and possibly unfair results.

19. Such problems had arisen under the 1917 law, which taxed the shareholders on certain "dividends" at rates in force during the year the dividend was earned rather than the year of payment. *Mason v. Routzahn*, 275 U. S. 175 (1927); *Edwards v. Douglas*, 269 U. S. 204 (1925). The former case held that it is the existence of earnings or profits at the date of payment of the dividend rather than at the date of declaration which determines the character of the distribution.

20. Of course, the provision would still make taxable a distribution out of the current year's earnings or profits, even if there were a deficit at the beginning of the year; but a corporation in such a situation will not often, in the absence of such a spur as a tax on undistributed income, pay any dividends.

21. Principally, personal holding companies (INT. REV. CODE § 500) and mutual investment companies (INT. REV. CODE § 362).

22. The law applicable to the taxable year of the shareholder determines the status of the distribution as to him. The law applicable to the corporation's taxable year determines the status of the distribution as to it. *G. C. M.* 18,602, 1937-2 CUM. BULL. 134.

23. U. S. Treas. Reg. 103, § 19.115-1.

to define the term.²⁴ Having in 1916 enacted a definition which excluded distributions out of earnings accumulated before March 1, 1913, the legislature soon learned that it had left a loophole: A corporation by declaring that a particular distribution was out of pre-1913 earnings, even though it had post-1913 earnings, could save its stockholders from tax.²⁵ To close this loophole, the 1917 law²⁶ added to the section defining a "dividend," a new subsection intended to prevent the distributing corporation's designation of the source of a distribution from affecting the tax liability of the stockholders, and designed to force a corporation to distribute its earnings after February 28, 1913 before it could dip into its earnings before that date. This was accomplished by the enactment of a conclusive statutory presumption to the effect that any distribution was deemed to have been made from the most recently accumulated earnings. Later, various other loopholes developed, notably the failure to tax distributions out of pre-1913 earnings even when such distributions exceeded the basis of the stock; but these were gradually stopped up (with one exception)²⁷ by a series of amendments,²⁸ extending over a period of more than twenty years.

This brings us to the existing provisions²⁹ relating to the source of corporate distributions. They embody two conclusive³⁰ presumptions:

a. Every distribution is out of earnings or profits to the extent thereof.

24. *Lynch v. Hornby*, 247 U. S. 339 (1918).

25. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938) 951 (Senate discussion).

26. Revenue Act of Oct. 3, 1917 (introduced August 6, 1917): § 1211 adding § 31 (b) to the 1916 Act. Distributions made between Jan. 1, 1916 (the effective date of the 1916 law) and Aug. 6, 1917 (the date specified in the 1917 law) and designated as having been made out of pre-1913 earnings, even if there were post-1913 earnings, were exempt. A. R. R. 1000, I-2 CUM. BULL. 11 (1922). (See also U. S. Treas. Reg. 103, § 19.115-3.)

27. A distribution out of pre-March 1, 1913 increase in value even when it exceeds basis still enjoys complete immunity. See p. 871 *infra*. Prior to 1936, a distribution out of pre-1913 earnings, even when in excess of basis, was similarly exempt; but in that year, a slight change in the verbiage of § 115 (d) had the effect, in the eyes of the Treasury at least, of making any such excess taxable (like gain from a sale). Before the 1936 Act, the subsection provided that if "any distribution . . . is not out of increase in value of property accrued before March 1, 1913 and is not out of earnings or profits, then the amount of such distribution" shall reduce basis, etc. The change consisted of substituting the word "dividend" for the italicized words. The committee reports seem to indicate that the complete significance of the change was not apparent to the committees. The Treasury Regulations issued under the 1936 Act reflected the change. Compare U. S. Treas. Reg. 86 (1934 Act), Art. 115-3, 115-4, with U. S. Treas. Reg. 94 (1936 Act), Art. 115-4.

28. 1918 Act, § 201 (b); 1921 Act, § 201 (b), (c); 1924 Act, § 201 (b), (d); 1932 Act, § 115 (d); 1936 Act, § 115 (d); 1939 Act, § 214 (b) amending § 115 (d) of the Internal Revenue Code.

29. INT. REV. CODE § 115 (b), (d).

30. *Faris v. Helvering*, 71 F. (2d) 610 (C. C. A. 9th, 1934); *Leland v. Commissioner*, 50 F. (2d) 523 (C. C. A. 1st, 1931); *Rheinstrom v. Commissioner*, 33 F. Supp. 917 (S. D. Ohio, 1940); A. R. R. 1000, cited note 26 *supra*.

b. Every distribution is out of the most recently accumulated earnings or profits.

Further, they state certain rules as to the effect of tax-free distributions on the stockholder's basis for his stock:

1. Distributions out of pre-1913³¹ earnings reduce basis and if in excess of basis become taxable as gains from the sale of property (in nearly all cases, capital gains). There can be no distribution of pre-1913 earnings until post-1913 earnings have been completely exhausted.

2. Distributions out of pre-1913 increase in value³² (whether such increase is realized after 1913 or remains unrealized) reduce basis, but any excess over basis does *not* become taxable. No distribution out of this source can be made until *all* earnings or profits, whether before or after March 1, 1913, are distributed.

3. Distributions out of any other source, e. g. post-1913 increase in value,³³ depletion or depreciation reserves based on cost, paid-in surplus, or paid-in capital, reduce basis and if in excess of basis become taxable as gains from the sale of property. Once all the earnings or profits (both before and after 1913) are exhausted, there is nothing in the law to prevent the distributing corporation from earmarking a distribution as being either out of class 2 or class 3 (assuming the existence of sources of both classes).

Because of the conclusive presumptions mentioned above, the corporate surplus,³⁴ or rather the source out of which any non-liquidating distribution may be made, may be likened to a well containing liquids of varying specific gravities. Having the lowest specific gravity, and hence always at the top of the well, will be the earnings and profits of the taxable year.³⁵ Directly below the earnings of the current year will be the accumulated earnings and profits of all past years, back as far as March 1, 1913.³⁶ The next lower layer consists of the earnings

31. The exact dividing line is March 1, 1913, but for convenience the terms "pre-1913" and "post-1913" are sometimes used herein.

32. This includes distributions out of depletion and depreciation reserves based on March 1, 1913 values to the extent that the value of the depletable or depreciable property on that date exceeds cost.

33. This includes distributions from 1924 through 1931 out of depletion reserves based on discovery value. See note 123 *infra*.

34. This is defined in *Edwards v. Douglas*, 269 U. S. 204 (1925), as "the net assets of a corporation in excess of all liabilities including its capital stock." As to the sources from which a corporation may legally pay a dividend (under local law), see Ballantine and Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws* (1935) 23 CALIF. L. REV. 229.

35. In the case of a company with an accumulated operating deficit, but with earnings or profits of the taxable year, there is in fact no surplus well; the taxable year's earnings are suspended, so to speak, in a vacuum.

36. Where property which takes as its income tax basis its value on March 1, 1913, is sold after that date, the 1913 date may act as a catalytic agent and precipitate earnings realized after 1913 to the lower levels of the well.

before March 1, 1913. This third layer and the segments that may lie below it³⁷ do not constitute a source out of which a "dividend" may be paid. These lower segments need not, therefore, be stratified for purposes of this article. The statutory presumptions forbid discriminate siphoning from the well until the top three sections are exhausted. The distribution of corporate surplus thus takes a predestined order; the three upper levels must be completely withdrawn *in order*, before the next lower layers are reached.³⁸ Bearing these rules in mind, we pass to a consideration of specific situations.

A. Corporations Which Have an Accumulated Operating Deficit but Which Have Earnings or Profits of the Taxable Year

As already indicated, a distribution takes its color for tax purposes from the earnings³⁹ status of the distributing corporation. Any distribution will be a "dividend" to the extent that there are earnings or profits of the year in which the distribution is made. (This means the year of payment and not the year of dividend declaration.) The earnings of the taxable year are determined as of the close of the year during which the distribution is made without diminution by reason of any distribution made during the year and without regard to the amount of earnings at the time of distribution.⁴⁰ Accordingly, even if there are no earnings of either past years or the current year at the time of a particular distribution, that distribution will be "a dividend" if later in the corporation's taxable year sufficient earnings are realized to cover the distribution.⁴¹ If there is only one distribution during the year and it is covered only in part by earnings—assuming there are no earnings of prior years—only that part will be a dividend;⁴² the remainder will be a return of capital. If there is more than one distribution during the year, and the earnings of the taxable year are not sufficient to cover the total distributions during the year—again assuming there are no earnings of past years—each distribution will be

37. These will consist of the sources listed under 2 and 3 on p. 871 *supra*.

38. From January 1, 1916 to August 6, 1917, the corporation could drop the siphoning tube to whichever level it chose. See note 26 *supra*.

39. The full term is "earnings or profits"; but for convenience, the single word "earnings" is sometimes used.

40. U. S. Treas. Reg. 103, § 19.115-1. This eliminates the difficulties inherent in a determination of whether at the date of distribution, i. e., payment, earnings of the taxable year exist in fact. See *Mason v. Routzahn*, 275 U. S. 175 (1927); *Edwards v. Douglas*, 269 U. S. 204 (1925); *Elmhirst*, 41 B. T. A. 348 (1940) (N A), pending before the Second Circuit Court of Appeals.

41. There may be a constitutional question as to whether a distribution which is clearly out of capital when made can become a "dividend" by virtue of subsequent profits in the same year.

42. Thus, if the distribution amounts to \$10,000 and the earnings to \$8,000, only the latter amount will be a dividend, the remaining \$2,000 will be applied in reduction of basis.

taxable in the proportion that the earnings of the year bear to the total distributions during the year.⁴³

Where there is preferred as well as common stock outstanding and distributions have been made on each class of stock, which distributions, in the aggregate, exceed the earnings of the taxable year—there being no earnings of past years—the Commissioner has ruled⁴⁴ that the earnings of the taxable year are regarded as having been first used to pay the dividends on the preferred stock and the earnings, if any, which remain after payment to the preferred stockholders will be regarded as having been paid to the junior stockholders.

B. Corporations Which Have Accumulated Earnings or Profits of Past Years

The situation here is complicated by the necessity for distinguishing between earnings accumulated prior to March 1, 1913, and those accumulated on and after that date.⁴⁵ That this is not a simple question is shown by the large number of cases and rulings in which the problem has arisen. Where a corporation is organized subsequent to March 1, 1913, and does not, by reason of a tax-free reorganization, take over the pre-1913 earnings of a predecessor company,⁴⁶ there can be no accumulation of earnings until an *operating* deficit is made good.⁴⁷ However, a different rule prevails where the deficit is caused not by operating losses but by distributions in excess of earnings. Thus, where

43. U. S. Treas. Reg. 103, § 19.115-2. This section of the regulations cites as an example a situation where the corporation had earnings of \$30,000 for the taxable year, but made four quarterly distributions of \$15,000 each, i. e., an aggregate of \$60,000. Thus, fifty per cent of each quarterly distribution was out of earnings of the taxable year. If the earnings of the taxable year are not sufficient to cover the total distributions during the year, but there are post-1913 earnings of past years sufficient to absorb the deficiency, all of the distributions during the year will be "dividends." But if in such a case, the post-1913 earnings of past years are not sufficient to cover the *entire* deficiency of the current year, the earnings of the past years are used to absorb the prorated portions of the deficiency in the year of the distribution. Thus, in the example referred to above, the corporation had \$12,000 of post-1913 earnings at the beginning of the taxable year. The aggregate deficiency of \$30,000 for the year of distribution is prorated to the four quarterly distributions. The deficiency prorated to the first distribution, \$7,500, reduces the accumulation of past earnings by \$7,500 and the remaining \$4,500 of past earnings are applied against the deficiency prorated to the second distribution; \$3,000 of that distribution and \$7,500 of each of the third and fourth distributions will not be a "dividend." A stockholder who sold his stock between the third and fourth dividends would be taxable on all of the first dividend and twelve-fifteenths of the second dividend. The buyer of the stock would be taxable on only 50% of both the third and fourth dividends. As previously indicated, that part of each distribution which was not a "dividend" would have to be applied in reduction of basis. See also U. S. Treas. Reg. 109, § 30.718-4.

44. G. C. M. 21,122, 1939-1 CUM. BULL. 187.

45. As heretofore indicated, only the latter can be the source of a "dividend."

46. See p. 895 *infra*.

47. Arthur C. Stifel, 29 B. T. A. 1145 (1934); Louise G. Shorb, 22 B. T. A. 644 (A) (1931). The same rule applies to a corporation organized before 1913. Hadden v. Commissioner, 49 F. (2d) 709 (C. C. A. 2d, 1931); Chapman v. Anderson, 11 F. Supp. 913 (S. D. N. Y. 1935); J. L. Washburn, 16 B. T. A. 1091 (1929). *Contra*: Blair v. United States, 63 Ct. Cl. 193 (1927), cited note 52 *infra*.

a corporation has earned \$10,000 and distributed \$12,000, the resulting deficit of \$2,000 need not be made good before there is an earnings accumulation.⁴⁸ The contrary interpretation would enable a corporation to make a distribution out of capital, restore the resulting impairment out of subsequent earnings and then repeat the process, thus defeating the legislative intent to tax distributions of post-1913 earnings.

While, in the case of a corporation organized after March 1, 1913, post-1913 operating losses must be less than post-1913 operating profits before there can be an accumulation of post-1913 earnings, a somewhat different rule applies to a corporation organized before March 1, 1913, which possessed an earnings accumulation on that date. Suppose the accumulated earnings on March 1, 1913 amount to \$200,000, and that from March 1, 1913 to December 31, 1938 the corporation each year suffered a net loss, such losses aggregating \$125,000. During this period it made no distributions. Suppose further, that in 1939 the corporation earned \$100,000 and that it distributed at the beginning of 1940, \$100,000. (It had no earnings during 1940.) What is the status of the 1940 distribution? Are there post-1913 earnings?

Viewing the period subsequent to March 1, 1913 as a unit, it is obvious that there were no earnings during this period. Rather, there was a deficit of \$25,000. On the other hand, what was in fact lost during the years from March 1, 1913 through 1938 was not the earnings of 1940 but rather the earnings which existed on March 1, 1913. A realistic appraisal of the situation would compel the conclusion that of the aggregate earnings of \$175,000 existing at the time of the distribution, only \$75,000 represented pre-1913 earnings. (The remainder of the pre-1913 earnings had been dissipated and could hardly be distributed.) This left \$100,000 of post-1913 earnings. The Supreme Court adopted this more realistic view in *Helvering v. Canfield*,⁴⁹ and held that the distribution in the circumstances stated would be a "dividend." The Court pointed out that although the 1913 surplus became capital from the viewpoint of the corporation, it was not frozen into capital so far as the stockholders were concerned;⁵⁰ and that, although it might have been distributed tax-free⁵¹ before it was dissipated by losses, the failure to distribute it subjected it to the risk of the business and when it was lost, the loss did not serve to reduce the post-1913 earnings. In other words, the fact that March 1, 1913 is a dividing

48. Stanley M. Bolster, Executor, 23 B. T. A. 347 (1931); F. W. Henninger, 21 B. T. A. 1235 (1931).

49. 291 U. S. 163 (1934). The rule of the *Canfield* case is incorporated in U. S. Treas. Reg. 103, § 19.115-3.

50. This had been decided by *Lynch v. Hornby*, 247 U. S. 339 (1918).

51. After January 1, 1916. See note 26 *supra*.

line does not make the accumulated earnings on that date static. A March 1, 1913 *paid-in surplus*, on the other hand, is frozen into capital even as to the stockholders, and subsequent losses are chargeable against future earnings in arriving at post-1913 earnings.⁵² The cases thus stand for the proposition that a loss for any particular year is chargeable first against pre-existing *earnings* and only after these are exhausted does it serve to reduce subsequent accumulations of earnings.⁵³

Other problems on the point of whether earnings arise before or after March 1, 1913 will be considered under heading IV of this article.

C. Corporations Which Have Neither Accumulated Earnings Nor Earnings of the Taxable Year

A distribution, made after the earnings of the taxable year and the accumulated post-1913 earnings of prior years have been fully exhausted, cannot be a "dividend." Such a distribution may be from one of the sources listed under 2 and 3 *supra*. If sources of each class exist and the distribution is not ear-marked, the Treasury will probably assert that it is out of class 3 for the reason that any excess of distributions out of that class over basis would be taxable whereas any excess of distributions out of class 2 over basis would not be taxable.⁵⁴ Examples of distributions out of each class follow:

Suppose a corporation which has completely distributed its earnings and profits (of the current year and of past years) owns non-depreciable property, say land, which cost it \$1,000 and which on March 1, 1913 had a value of \$10,000. A distribution of the land in kind, or a distribution of cash against a credit to surplus account⁵⁵ representing the pre-1913 increase in value of the land, would be out of class 2 and would not be a "dividend." The same result would follow if the corporation sold the land for \$10,000 and distributed the proceeds.⁵⁶

52. Roy J. Kinnear, 36 B. T. A. 153 (1937). *Contra*: Blair v. U. S., 63 Ct. Cl. 193 (1927). The Blair case appears to be overruled by Willcuts v. Milton Dairy Co., 275 U. S. 215 (1927).

53. Where a taxpayer asserts that a particular distribution is out of pre-1913 earnings rather than post-1913 earnings, the burden of proof, as in nearly all other tax cases, rests on him. Faris v. Helvering, 71 F. (2d) 610 (C. C. A. 9th, 1934); Annie P. Kountze, 17 B. T. A. 928 (1929); G. L. Holton, Executor, 7 B. T. A. 163 (1927). See also Binzel v. Commissioner, 75 F. (2d) 989 (C. C. A. 2d, 1935), *cert. denied*, 296 U. S. 579 (1935). And, if the corporation is a foreign corporation the question of whether it has earnings or profits will be determined by our law and not that of the foreign country. Edward D. Untermeyer, 24 B. T. A. 906 (1931); *aff'd*, 59 F. (2d) 1004 (C. C. A. 2d, 1932), *cert. denied*, 287 U. S. 647 (1932).

54. See p. 871 *supra*.

55. A writing up of assets with a corresponding credit to surplus representing the appreciation does not create earned surplus. (Presumably, *earned surplus* means the same thing as earnings or profits.) La Belle Iron Works v. United States, 256 U. S. 377 (1921).

56. I. T. 1303, I-1 CUM. BULL. 17 (1922). In Hoffman v. United States, 53 F. (2d) 282 (1931), it was held that the 1921 law which was the first to specifically exempt distributions out of pre-1913 increase in value, was merely declaratory of the

Next, suppose the property instead of being non-depreciable were depreciable or depletable, that the depreciated or depleted cost at March 1, 1913 was \$1,000 and that the value of the property on that date was \$10,000. A distribution charged against a depreciation or depletion reserve based on the latter figure would be out of class 2 to the extent of the excess of such depreciation or depletion over depreciation or depletion based on cost.⁵⁷

To revert to the first example, if the land in question had been purchased subsequent to March 1, 1913 for \$1,000, were distributed in kind, and were worth \$10,000 at the date of distribution, the distribution would not be a "dividend" but would fall within class 3; it would be out of *post*-1913 increase in value.⁵⁸ Similarly, a distribution in cash against a credit to surplus representing the appreciation would be within class 3. But, if the corporation sold the land before making distribution, the sale would convert the *post*-1913 increase in value into earnings and a distribution thereafter would be a "dividend" to the extent of such earnings.

Other distributions out of class 3 would comprise distributions out of depletion or depreciation reserves based on cost, distributions out of paid-in surplus, and out of amounts paid in for stock. It should constantly be borne in mind that no distribution can be made out of the sources just discussed unless and until *all* earnings and profits have been exhausted, either by offsetting losses or by prior distributions.

IV. THE MEANING OF "EARNINGS OR PROFITS"

We now come to the major item on the agenda of this article. By way of emphasis, let it be repeated that before any corporate distribution can be a "dividend," the distributing corporation must possess *post*-1913 earnings or profits, either of the current year (regardless of a pre-existing deficit) or of past periods subsequent to February 28, 1913. Let it also be reiterated that *all* the earnings or profits, whether before or after March 1, 1913, must be distributed (although only the latter would constitute a "dividend") before there can be a distribution out of any other source. An ascertainment of the meaning of the term "earnings or profits" (before as well as after March 1, 1913) is, therefore, of paramount importance if we are to determine the character of a particular distribution. The problem currently takes an added significance by reason of the fact that, under the new excess-profits tax

prior law which did not specifically exempt such distributions but did exempt earnings "accrued" prior to March 1, 1913.

57. U. S. Treas. Reg. 103, § 19.115-6.

58. Cf. *Binzel v. Commissioner*, *supra* n. 53, and see p. 902 *infra*.

law,⁵⁹ earnings and ⁶⁰ profits are a part of equity invested capital and may have an important effect on the amount of excess-profits tax liability when the excess-profits credit is based on invested capital.⁶¹

Until the Second Revenue Act of 1940, Congressional concern, perhaps it would be more accurate to say lack of concern, as to the meaning of earnings or profits was rarely expressed in legislation. True, provisions had been enacted, designed to prevent the depletion of earnings by certain liquidating distributions⁶² and by certain tax-free distributions in connection with reorganizations,⁶³ in order to safeguard the tax on subsequent distributions; but no definition of the term comparable to the definition of a "dividend" was attempted. This left the burden of exegesis to the taxpayer, the Treasury, the Board and the courts. All were agreed that earnings or profits did not mean the same thing as taxable net income. To take perhaps the most obvious example of difference, the corporation's own income tax, which is not deductible in computing taxable net income, must clearly come off in calculating earnings, since the payment of that tax depletes the amount available for distribution to stockholders.

While all the interested parties were in agreement that earnings and taxable net income were not synonymous, the concordance stopped there. The Treasury itself maintained opposite views at one and the same time.⁶⁴ Most of the divergent views of the Treasury, on the one hand, and the Board and the courts, on the other, have now been harmonized by the amendments to Section 115 of the Code added by the Second Revenue Act of 1940.⁶⁵ These amendments, in general, merely impress the legislative stamp of approval upon the position theretofore taken by the Treasury. As will hereinafter be shown, the 1940 amendments have not solved all of the riddles encountered in ascertaining

59. Not to be confused with the "declared value excess-profits tax."

60. In the excess profits tax law (INT. REV. CODE § 718 (a) (4)), and in §§ 115 (l) and (m) of the Code (added in 1940) the conjunctive form of the term is employed. Prior to 1940, only the disjunctive form had been used in the income tax laws, except that in the 1918 Act the phrase appears in both forms. No one has suggested that the use of "and" signifies any different meaning than when "or" is employed.

61. Even when the excess profits credit is based on average base period income (§ 713), earnings and profits may be of importance because of required adjustments on account of capital changes. § 713 (c) (4).

62. Discussed p. 899 *infra*.

63. Discussed p. 897 *infra*.

64. Cf. Susan T. Freshman, 33 B. T. A. 394 (1935) and F. J. Young Corp., 35 B. T. A. 860 (1937).

65. Section 501 (a) of the second 1940 Act added subsections (l) and (m) to § 115 of the Code. By virtue of § 510 (b) and (c) these amendments are applicable not only to years covered by the Code (years beginning after December 31, 1938) but to all prior years as well, except as to the tax liability for any year, which on September 20, 1940 was pending or determined by the Board or any of the courts. As to the validity of the retroactive feature of the amendments, cf. Wilgard Realty Co., 43 B. T. A., No. 77, Feb. 12, 1941.

earnings or profits, and there will continue to exist disparity of opinion as to the meaning of the term.

A. *Earnings or Profits in General*

The dictionary⁶⁶ defines "earnings" simply as wages, and, although this connotes primarily compensation for labor, Congress in employing the word "earnings" undoubtedly meant it to include the wages of capital (dividends, interest, rents, etc.) and even of sin.⁶⁷ The term "profits" is more comprehensive. It is defined as "the excess of income over expenditures, as in a business, during a given period of time." Except for the fact that it connotes the existence of a business, the definition is wide enough to include all "earnings." It contemplates transactions in which there is an outlay and is sufficiently broad to embrace *income*⁶⁸ of every character and expenditures of every character.⁶⁹ The definition also plainly envisages the *realization* of income. Hence, mere appreciation in value without being reduced to receipt (through conversion into cash, other property, or a contract right), and mere decline in value⁷⁰ which has not been crystallized by sale or other disposition, do not enter into the ordinary concept of earnings or profits, even though the economist, the lawyer, the accountant, and the business man who is attuned to realities, would not approve the declaration of a corporate dividend without taking into account unrealized fluctuations in the value of the company's property.⁷¹ Thus, book entries reflecting unrealized appreciation or depreciation will not create or deplete earnings or profits.⁷² Similarly book entries transferring earned surplus to capital stock will not reduce earnings or profits.⁷³

Although book entries of the kind just mentioned do not affect earnings or profits, the general bookkeeping method employed by the corporation does have a vital bearing on the amount of its earnings. The company's method of accounting, if it clearly reflects income, must be followed in arriving at its taxable net income,⁷⁴ and it has been

66. WEBSTER'S COLLEGIATE DICTIONARY (5th ed.).

67. *United States v. Sullivan*, 274 U. S. 259 (1927).

68. This would exclude capital receipts, i. e., contributions to capital.

69. In the case of a capital expenditure, it is generally accepted that it is only an offset to the income in proportion to the exhaustion of the capital asset acquired by the expenditure.

70. This excludes declines in value due to physical or other exhaustion of capital assets.

71. *Helvering v. National Grocery Co.*, 304 U. S. 282, 291 (1938).

72. *La Belle Iron Works v. United States*, 256 U. S. 377 (1921). See also U. S. Treas. Reg. 103, § 19.115-3, and *Senate Finance Committee Report on Second Revenue Act of 1940*, SEN. REP. NO. 2114, 76th Cong., 3d Sess. (1940) 25.

73. *F. J. Young Corp.*, 35 B. T. A. 860 (1937), *aff'd without discussion of this point*, 103 F. (2d) 137 (1939). *Chapman v. Anderson*, 11 F. Supp. 913 (1935).

74. INT. REV. CODE § 41, U. S. Treas. Reg. 103, § 19.41-1. I PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 11.13.

uniformly held that the same method of accounting which is used for determining taxable net income must be used in arriving at earnings or profits. Thus, where the chargeoff method is used for deducting bad debts in calculating income tax, the reserve method may not be used for determining earnings or profits.⁷⁵ If the company employs the accrual method of accounting for fixing its taxable net income, it may not use the cash basis in establishing the amount of its earnings, and vice versa.⁷⁶

In *Wells Fargo Bank v. McLaughlin*⁷⁷ and in *Corrine S. Koshland*,⁷⁸ the status of certain distributions by a public utility turned upon the adequacy of depreciation deductions. It was held that the amounts of depreciation deducted by the corporation in fixing its income tax (and allowed by the Commissioner) were conclusive in arriving at earnings, despite the fact that the depreciation deducted in the company's accounts, pursuant to state regulations, was much greater.⁷⁹ In each of these cases, however, it was found as a fact that the depreciation deducted on the returns was correct. If it were not correct, presumably a different rule would apply. Thus, in *Neptune Meter Co. v. Price*,⁸⁰ it was held that amounts erroneously charged off by way of patent depreciation in earlier years should be restored to earnings, even though the erroneous chargeoff had been allowed by the Commissioner in such earlier years.⁸¹ It would follow that if depreciation is inadequate, earnings will have to be adjusted downwards.⁸²

Keeping these general principles in mind, we pass to a consideration of, first, the differences between taxable net income and earnings or profits, and, second, the effect of particular transactions on earnings or profits.

B. Reconciliation of Taxable Net Income and Earnings or Profits

Any attempt to stake out the boundaries of earnings and profits must begin with a point of orientation. The book surplus is not a satisfactory starting point since it will vary with the accounting method

75. *Neptune Meter Co. v. Price*, 98 F. (2d) 76 (C. C. A. 2d, 1938); *Benjamin Siegel*, 29 B. T. A. 1289 (1934).

76. G. C. M. 2951, VII-1 CUM. BULL. 160 (1928); I. T. 3253 1939-1 CUM. BULL.

178. *Cf. Hadden v. Commissioner*, 49 F. (2d) 709.

77. 78 F. (2d) 934 (C. C. A. 9th, 1935), *cert. denied*, 296 U. S. 638 (1935).

78. 33 B. T. A. 634 (1936).

79. *Cf. Commissioner v. Pittsburgh Brewing Co.*, 107 F. (2d) 155 (C. C. A. 3d, 1940).

80. Note 75 *supra*.

81. The invested capital cases are to the same effect: e. g., *J. C. Blair Co.*, 11 B. T. A. 673, 681 (1928). But note the effect of § 734 of the Code, added by § 11, Excess Profits Tax Amendments of 1941.

82. Presumably, the special amortization deduction now allowed by § 23 (t) and § 124 will deplete earnings to the same extent it reduces net income.

of the corporation and the judgment of its officers and auditors. The taxable net income, on the other hand, is a uniform standard, and hence, the logical point of beginning. What, then, must be added to and what must be subtracted from taxable net income to arrive at earnings or profits?

1. Items Specifically Excluded from Gross Income by Section 22 (b) of the Internal Revenue Code

This group will comprise (a) certain life insurance proceeds; (b) that portion of annuities which is treated as a return of capital; (c) property acquired by gift, bequest, or devise; (d) interest on municipal and state bonds and on tax-exempt federal obligations; (e) compensation for personal injuries and for sickness of employees, whether as insurance or as damages; and (f) income from discharge of certain indebtedness.⁸³ Those stockholders who are subject to tax as individuals (including partners, fiduciaries and beneficiaries) will want all of these items excluded from earnings. On the other hand, incorporated stockholders (this will include certain associations) and the corporation itself (for purposes of excess-profits tax computation) will want them included in earnings and profits. Thus, considering the corporation and its stockholders as separate entities, their interests may be conflicting.

(a) Life insurance proceeds: Suppose a corporation has insured the life of one of its officers for \$100,000. The officer dies and the corporation receives the proceeds tax-free. It immediately distributes such proceeds to its stockholders. Is the distribution a "dividend"? If the corporation's earnings, apart from the insurance proceeds, exceed \$100,000, the distribution is clearly a dividend,⁸⁴ since *every* distribution is made out of earnings to the extent thereof. But, if there were no earnings apart from the insurance proceeds, it would be necessary to decide whether such proceeds constituted earnings. It has been stated by way of dictum that they do.⁸⁵

Although a plausible argument may be made for the point that life insurance proceeds should retain their immunity on passing through

83. The remaining subdivisions of § 22 (b), except possibly subdivision (7), income exempt under treaty (which might affect a foreign corporation), would have no bearing on the problems considered herein.

84. *Cummings v. Commissioner*, 73 F. (2d) 477 (C. C. A. 1st, 1934); *Golden, Executrix*, 39 B. T. A. 682 (1939), *aff'd*, 113 F. (2d) 590 (C. C. A. 3d, 1940); *Isaac May*, 20 B. T. A. 282 (1930). The reasoning of the *Cummings* case has been justly criticized, PAUL, *STUDIES IN FEDERAL TAXATION, SECOND SERIES* (1938) 161-164, but the result appears to be plainly correct.

85. *Cummings v. Commissioner*, 73 F. (2d) 477 (C. C. A. 1st, 1934). In *Isaac May*, 20 B. T. A. 282 (1930), where there was no evidence as to accumulated earnings, the Board raised a doubt as to whether the distribution of the insurance proceeds would be a dividend if there were no such earnings.

the corporation, the sounder view appears to be to the contrary. The corporation and its stockholders are separate entities and the exemption, as in the case of other exemptions, is granted to the corporation, not to its stockholders. The corporation is not merely a conduit; its stockholders are not taxed on its income prior to distribution.⁸⁶ The identity of the insurance proceeds is lost in the distribution.⁸⁷ Moreover, it may be assumed that the purpose of Congress in exempting life insurance proceeds is to encourage such insurance for the protection of dependents or those who would be injured by the death of the insured. The protection motive, in the case of a corporation which takes out life insurance, is tainted by the fact that what is presumably insured against is a loss of future profits, which, if realized, would be taxable. Moreover, distribution by the corporation negatives the notion that protection was needed, so far as the corporation, as distinguished from its shareholders, is concerned, and converts the policy into an investment rather than a protective device.⁸⁸ Still further, the net premium cost of the policies,⁸⁹ even though not deductible,⁹⁰ ordinarily reduces earnings⁹¹ and hence the return of the premiums and their increment in the form of the proceeds of the policy should be restored to earnings.⁹²

(b) Annuities: Where the corporation enters the entire cost of the annuity contract on its books as an asset, reducing it annually by that portion of the annuity which is deemed to be a return of capital under Section 22 (b) (4), i. e., all above 3% annually of cost, the treatment of this item for the purpose of determining earnings should coincide with its treatment for determining taxable net income. Where, however, the corporation charges against earnings the difference between cost of the annuity and cash surrender value, the credits to earned surplus will begin before the exempt portions of the annuity equal its cost.⁹³

86. Except in unusual situations, e. g., foreign personal holding companies.

87. PAUL, *op. cit. supra* note 84, at 161.

88. This is suggested in the opinion in *Cummings v. Commissioner*, 73 F. (2d) 477 (C. C. A. 1st, 1934).

89. In the case of a policy having cash surrender value, the net premium cost would be the difference between the net premium and the increase in cash surrender value.

90. INT. REV. CODE § 24 (a) (4).

91. P. 888 *infra*.

92. Where the insurance payable by reason of death is greater because paid in instalments, it has been held that the extra payment is not taxable (*Commissioner v. Winslow*, 113 F. (2d) 418 (1940); *Commissioner v. Bartlett*, 113 F. (2d) 766 (1940)), but the principles suggested in the text should not be affected in such a case. In the case of insurance proceeds received prior to the death of the insured, the adjustment to earnings would consist of the excess of such proceeds over the cash surrender value at which the policy was being carried on the books. As to such proceeds, any excess over net cost of the policy would not be exempt.

93. There do not appear to be any rulings or cases on the treatment of annuities in fixing earnings.

(c) Gifts, bequests and devises: In *Cummings v. Commissioner*,⁹⁴ it is suggested by way of dictum that a gift⁹⁵ to a corporation would constitute earnings or profits. Presumably, the same suggestion would have been made as to a bequest or devise. From the standpoint of sheer logic, it is difficult to support this conclusion. Although a gift, bequest or devise may increase surplus, it is not, according to common parlance, "earned" nor is it a profit.⁹⁶ Moreover, unlike life insurance proceeds, such an accretion is not a substitute for lost profits. While apart from legal considerations, a fairly good argument might be made for treating distributions from any source, other than paid-in capital, as "dividends," it does not appear that Congress intended to go so far, since it limited "dividends" to distributions out of post-1913 earnings or profits. Admittedly, Congress has power to tax a distribution out of a gift, bequest or devise to the corporation,⁹⁷ but, as pointed out by Mr. Paul, we must not confuse "what Congress may constitutionally do and what it has tried to do."⁹⁸

(d) Interest on tax-exempt bonds: No one seems to question the propriety of including this item in earnings or profits.⁹⁹ Unlike a gift, bequest or devise, tax-exempt interest is clearly income and there can be little doubt that Congress intended it to be compassed by the term "earnings or profits."

(e) Compensation for injuries or sickness: It has recently been held¹⁰⁰ that such income, even when received by a corporation, is exempt by virtue of the provisions of Section 22 (b) (5). However, for the reasons stated above with respect to life insurance proceeds, there is no sufficiently persuasive ground for excluding such income from earnings or profits.

(f) Income from discharge of certain indebtedness, by corporations in an unsound financial condition, pursuant to Section 22 (b) (9): This subsection, which was designed as a partial solution to the

94. 73 F. (2d) 477 (C. C. A. 1st, 1934), cited note 84 *supra*.

95. A gift (or a bequest or devise) must be distinguished from a contribution to capital. The latter clearly does not become a part of earnings and profits. (Note, however, *Blair v. United States*, 63 Ct. Cl. 193 (1927) and *I. T. 1924*, III-1 CUM. BULL. 27 (1924), both of which seem to be overruled by later decisions.) Admittedly, it will be difficult in some cases to distinguish between gifts and contributions to capital. See *Frank B. Thompson*, 42 B. T. A. 121 (1940); *cf. Helvering v. Hutchings*, 9 U. S. L. WEEK 4233 (U. S. 1941); *Robert H. Scanlon*, 42 B. T. A. 997 (1940).

96. PAUL, *op. cit. supra*, note 84, at 164.

97. The exemption is not complete because the distribution of the property to the stockholders—assuming it to be not out of earnings—would have to be applied in reduction of the basis for the stock, and, if in excess of that basis, the excess would be taxable as a capital gain.

98. PAUL, *op. cit. supra* note 84, at 161.

99. U. S. Treas. Reg. 103, Art. 19,115-3. *R. M. Weyerhaeuser*, 33 B. T. A. 594, 597 (1935); *Charles F. Ayer*, 12 B. T. A. 284, 287 (1928).

100. *Castner Garage, Ltd.*, 43 B. T. A. No. 1, Dec. 4, 1940.

problem of whether the cancellation of indebtedness gives rise to taxable income,¹⁰¹ was first added by the 1939 Act.¹⁰² Under certain circumstances, it permits the exclusion of the differential between the issue price of a corporation's bonds and the price at which the corporation buys in the bonds (with an appropriate adjustment for unamortized bond premium or bond discount), at the expense of a reduction in the basis of the corporation's assets. This situation presents a difficult problem: Should the untaxed income be added to earnings (or reduce the deficit), and, if so, what should be done about the enforced reduction of basis? As to the latter, it should be noted that on a sale of the assets, the amount that would enter into earnings would be the difference between the *reduced* basis and the proceeds of sale,¹⁰³ so that *at that time* the untaxed income, at least to the extent of the basis reduction,¹⁰⁴ will become part of earnings. On this premise it should be ruled that no adjustment of the earnings account should be made to reflect the increase in surplus on account of the debt cancellation. Such treatment would be in line with the policy, now definitely established, of excluding gain on the sale of property from earnings if such gain is not recognized in computing net income.¹⁰⁵ From the viewpoint of the stockholder, the question is probably academic, at least temporarily, for the reason that such a corporation is unlikely to make any distribution to its stockholders. But from the corporation's angle, the question may be quite important as it may affect the corporation's excess-profits tax liability.

As to cancellation of indebtedness generally, any income resulting therefrom which is taxable should, of course, be included in earnings, not merely because it operates to make available to the stockholders a larger amount for the payment of dividends, but because it constitutes a profit in the generally accepted sense of the word. In the case of cancellation of indebtedness which does not produce income because the debtor remains insolvent after the cancellation,¹⁰⁶ there is no enforced reduction of basis, and unless the cancellation is reflected in earnings at the time of release, it will never be included therein. The

101. On this subject, see Darrell, *Discharge of Indebtedness and the Federal Income Tax* (1940) 53 HARV. L. REV. 977; Paul, *Debt and Basis Reduction Under the Chandler Act* (1940) 15 TULANE L. REV. 1; Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness* (1940) 49 YALE L. J. 1153.

102. § 215 (a).

103. INT. REV. CODE § 115 (1); U. S. Treas. Reg. 103, § 19.115-12. See p. 892 *infra*. The same rule would apply with respect to depreciation.

104. The reduction in basis may be smaller than the cancelled indebtedness. U. S. Treas. Reg. 103, § 19.113 (b) (3)-1.

105. From a realistic viewpoint, this treatment will result in an ultimate distortion of earnings if the assets are never sold or are of a type that is not subject to depreciation charges. But this inconsistency will apply to *all* continuing transactions where the property received in the tax-free exchange is never sold.

106. This is still not yet finally settled. See Paul, *loc. cit. supra* note 101, at 5.

question will be moot so far as distributions to stockholders are concerned, but excess profits tax liability of the corporation may be vitally affected.¹⁰⁷

2. Other items excluded from gross income

The items discussed under the preceding heading include only receipts or types of income which are specifically excluded by Section 22 (b). There are, however, other items of receipt which are not included in income. First, there is constitutionally exempt income,¹⁰⁸ if any. Second, there is realized income which is not recognized or taxed, because of either the failure of Section 22 (a) to include it, the provisions of Section 115 itself, or the tax-free exchange provisions of Section 112 of the Code. In theory, the taxation of income of the last mentioned type is merely postponed, but actually, in many instances, it completely escapes taxation. Included in the first group might be¹⁰⁹ a stock dividend of common on common.¹¹⁰ The second group would contain distributions received by *A* Corporation from *B* Corporation which are income in the ordinary sense but which are not "dividends" under Section 115, non-recognized gain from certain exchanges, and possibly gains from dealings in the stock of the corporation itself (treasury stock). Only the first of the items in this second group is considered at this point.¹¹¹

Suppose Corporation *A* owns stock in Corporation *B*. The latter makes a distribution which is not a "dividend," say out of *B*'s pre-1913 earnings. Does this distribution become part of the earnings of *A*? There are sound practical reasons calling for a positive answer, but Congress, in the interests of an integrated statute has answered in the negative.¹¹² Section 115 (1) of the Code¹¹³ (added by the Second Revenue Act of 1940, but effective as to earlier years

107. It will be possible for such a corporation to have earnings because the decline in value of the corporation's assets may be unrealized; and if the corporation is included in a consolidated return, its deficit may affect the excess profits tax liability of the group. U. S. Treas. Reg. 110, § 33.31 (a) (20).

108. Interest on state and municipal bonds, although specifically excluded by § 22 (b) may possibly fall into the constitutionally exempt category.

109. The recent amendment to § 19.115-7 of U. S. Treas. Reg. 103 is significant. It replaces the somewhat elaborate distinction between a taxable and non-taxable stock dividend with a single sentence which virtually repeats § 115 (f) (1) of the Code, and presages a frontal attack on the remains of *Eisner v. Macomber*, 252 U. S. 189 (1920). See Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code* (1939) 49 YALE L. J. 171, 210-211.

110. The effect of stock dividends (whether taxable or exempt) on earnings or profits is discussed below under a separate heading and is, therefore, not considered at this point.

111. The other two items are discussed under separate headings below.

112. The Board, even in the absence of a specific provision, had so ruled (6 members dissenting). *Arthur C. James*, 13 B. T. A. 764 (1928), *aff'd*, 49 F. (2d) 707 (C. C. A. 2d, 1931).

113. INT. REV. CODE § 115 (1), fourth sentence.

as well) provides that where a corporation receives a distribution from a second corporation which is not a "dividend," the amount of the distribution, to the extent that it must be applied in reduction of basis, is not added to earnings. (The implication is that any *excess* over basis, even if not taxable, must be added to earnings.) The reason for this provision becomes clear upon reference to the second sentence of Section 115 (1) which provides that gain or loss on the sale or other disposition (after February 28, 1913) of property shall increase or decrease earnings only to the extent that such gain or loss was recognized in computing net income. Accordingly, unless distributions which reduce basis are excluded from the earnings of the stockholder corporation, there will be a double inclusion, once on receipt and again on a sale of the stock.¹¹⁴ The effect of the statutory provision is the same as if earnings were increased by the tax-free distribution and reduced by the enforced reduction of basis.¹¹⁵

3. Allowable Deductions or Credits Which Do Not Deplete Earnings or Profits

A group of items somewhat analogous to excluded income, comprehends artificially created deductions or credits which are allowed for purposes of computing taxable net income,¹¹⁶ but which do not represent actual expenses or expenditures, i. e., there is no outlay by the corporation for the deductions or credits represented by such items. This group includes (a) that part of intercorporate "dividends" which is allowed as a deduction or credit, (b) interest on certain federal obligations, (c) loss carryovers, and (d) excess of percentage or discovery depletion over depletion based on cost or other basis.

(a) Intercorporate "dividends": "Dividends" received by one corporation from another domestic corporation have, in effect, been exempt from corporate normal income tax either in whole or to a major degree since 1917.¹¹⁷ Currently, they are exempt to the extent of 85%, subject to the limitation that the credit may not exceed 85% of the adjusted net income. The exemption is, of course, bottomed on

114. For example, suppose A Corporation owns stock with a basis of \$1,000. It receives a distribution of \$500 which it must apply in reduction of basis, reducing the latter to \$500. Upon sale of the stock for \$1,500, it will have a taxable gain of \$1,000 (which is its real gain if the \$500 distribution be counted in), all of which must be added to earnings. Unless the \$500 distribution were excluded from earnings, the latter would be artificially overstated by \$500. For another example, see U. S. Treas. Reg. 103, § 19.115-13 (Example 1).

115. The chief criticism of this rule is that if the stock with respect to which the distribution is made is never sold, the ultimate distribution to the stockholders of the receiving corporation may escape the tax applicable to dividends.

116. That is, income subject to corporation normal tax.

117. HOLMES, FEDERAL TAXES (6th ed. 1925) 251.

the desire to prevent an undue dilution of the original corporation's earnings by successive taxes on the corporations included in a pyramid; but once the earnings sift down to an individual stockholder, there is no reason why they should not be taxed as "dividends," and there has never been any question but that such exempt intercorporate "dividends" must be included in earnings or profits.

(b) Interest on certain federal obligations and on obligations of federal instrumentalities: Interest of this character, which is exempt from normal tax, must be added back to taxable income to arrive at earnings and profits. No question has been raised as to the propriety of this adjustment.

(c) Loss carryover: The current law allows,¹¹⁸ and some of the earlier laws allowed, a corporation to carry forward a net loss of one year, subject to certain limitations, against the income of the next year or of the next two years. But this deduction, which may be allowable for computing income tax, must clearly be added back to taxable income to arrive at earnings or profits.¹¹⁹ Otherwise, the same loss would be reflected in earnings twice.

(d) Percentage or discovery depletion: The Treasury Regulations have for many years provided¹²⁰ that in computing earnings or profits, depletion is based only on cost or other basis, and that discovery depletion¹²¹ and percentage depletion¹²² should not be taken into consideration in computing earnings or profits. Hence, the excess of such depletion over depletion computed on cost or other basis must be added back to taxable net income to arrive at earnings or profits.¹²³ This position is now fortified by the third sentence of Section 115 (1) which provides that where, in arriving at adjusted basis for computing gain or loss on sale or other disposition (for purposes of ascertaining taxable net in-

118. INT. REV. CODE §§ 23 (s), 122.

119. R. M. Weyerhaeuser, 33 B. T. A. 594 (1935).

120. The current provision is U. S. Treas. Reg. 103, § 19.115-3 as amended by T. D. 5024, Dec. 19, 1940.

121. Currently allowed with respect to certain mines under § 114 (b) (2) and (4) of the Code. Under some prior laws, discovery depletion was allowed with respect to other types of mines and with respect to oil and gas wells.

122. Currently allowed with respect to oil and gas wells under § 114 (b) (3) of the Code. The allowance of percentage depletion constitutes a needless subsidy to the owners and lessees of oil and gas wells. The theory behind it is that it obviates the complicated calculations necessary to ascertain depletion based on cost. However, such calculations are required anyway, as to corporations at least, in arriving at earnings or profits.

123. Charles F. Ayer, 12 B. T. A. 284 (1928); cf. Elton Hoyt, 2d., 34 B. T. A. 1011 (1936). The Ayer case was decided under the 1921 Act which did not specifically treat a distribution out of a depletion reserve based on discovery value as a return of capital. The Hoyt case was decided under the 1928 Act which did contain a specific provision to that effect and this accounts for the difference in result. The 1932 Act repealed the exemption provision which was first enacted in 1924. Hence the Ayer case is still applicable.

come), the adjustments required differ from those proper for determining earnings or profits, the latter shall be used in computing the increase or decrease in earnings resulting from the sale or other disposition. To illustrate, suppose the corporation purchased an oil well in 1937 for \$10,000, that it has been allowed percentage depletion from 1937 to 1940 inclusive amounting to \$2,000, that depletion based on cost would amount to \$1,000, and that the well is sold in 1940 for \$10,000. The adjusted basis of the well for computing gain or loss would be \$8,000; the original cost must be reduced by the depletion allowed, i. e., \$2,000. But in determining earnings, percentage depletion, to the extent it exceeds depletion computed on cost or other basis, is ignored. Hence, the basis used in calculating earnings is \$9,000. Thus, although the taxable gain is \$2,000, the increase in earnings is only \$1,000. This compensates for the fact that the excess depletion of \$1,000 never reduced earnings.¹²⁴

4. Unallowable Deductions

A converse group to that just discussed consists of expenses and losses which are not allowed as deductions in computing taxable net income, but which clearly deplete the income available for distribution to the stockholders. These items must be deducted in computing earnings or profits. This group includes (a) non-deductible income and excess profits taxes, (b) disallowed losses, (c) non-deductible life insurance premiums, (d) unreasonable compensation, unallowable contributions, and other disallowed expense items.

(a) Income and excess profits taxes: Such taxes, if not deducted in arriving at taxable net income, must be deducted from the latter figure to reach earnings.¹²⁵

(b) Disallowed losses: This does not refer to realized losses which are *not recognized* under Section 112; losses of the latter type are now specifically excluded in computing earnings by the second sentence of Section 115 (1). The caption relates only to "losses disallowed or not taken into account, such as those under Section 24 (b) [losses on sales by the corporation to a controlling stockholder] Section 118 [wash sales losses], and Section 117 of the Code [disallowed cap-

124. For another example, see U. S. Treas. Reg. 103, § 19.115-12, second Example (1). See also *Ways and Means Committee Report*, H. R. REP. No. 2894, 76th Cong., 3d Sess. (1940) 42; *Senate Finance Committee Report*, SEN. REP. No. 3002, 76th Cong., 3d Sess. (1940) 60-61.

125. The question of *when* they deplete earnings has been litigated in a number of excess-profits tax cases, e. g., *Fawcus Machine Co. v. United States*, 282 U. S. 375 (1931); cf. *L. S. Ayers & Co., I B. T. A. 1135* (1925). The proper rule would seem to depend on whether the taxpayer was on the cash or accrual basis. This is the position taken in the new excess profits tax regulations. U. S. Treas. Reg. 109, § 30.718-2. Cf. *Hadden v. Commissioner*, 49 F. (2d) 709 (1931).

ital losses¹²⁶].” The quoted language is taken from the Senate Finance Committee Report.¹²⁷ The Treasury Regulations repeat the three section numbers and state that “the mere fact that [such a loss] is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss.”¹²⁸

The inclusion of wash sales losses in this category is questionable if not erroneous. Where a wash sales loss has been disallowed, it is permitted to be added to the basis of the stock, purchase of which resulted in disallowance.¹²⁹ On a sale of the latter stock, the gain or loss “recognized” will, therefore, take into account the disallowed loss. Hence, unless it is excluded the first time, earnings will be depleted twice by the same loss, and the very coordination aimed at by the second sentence of Section 115 (1) will be destroyed. To illustrate, suppose a corporation sells bonds which it owns, at a loss of \$1,000. Within 30 days it repurchases the same bonds for \$10,000. The repurchase will prevent allowance of the \$1,000 loss, but such loss may be tacked onto the \$10,000 cost of the later acquisition. If the repurchased bonds are later sold for \$12,000, the recognized gain will be \$1,000, and in fact the net result of the series of transactions is an actual gain of \$1,000 (\$2,000 gain on the second sale less \$1,000 loss on the first one). However, if earnings must be depleted by the disallowed loss, the net increase in earnings will be zero. Accordingly earnings will be distorted to the extent of \$1,000.¹³⁰

(c) Disallowed life insurance premiums:¹³¹ The payment of such premiums, or rather, the excess of such premiums over increase in cash value, reduces the income available for distribution to the stockholders and hence should be taken into account in the determination of earnings or profits.

(d) Disallowed compensation and other disallowed expenses: This refers to unreasonable compensation,¹³² disallowed contributions,¹³³ and to certain unpaid expenses and interest.¹³⁴ These items,

126. Under current law, § 117 (d), this would be net short term capital loss. Any carryover of such loss would not enter into earnings. See p. 886 *supra*.

127. SEN. REP. NO. 2114, 76th Cong., 3d. Sess. (1940) 23.

128. U. S. Treas. Reg. 103, § 19.115-12. Presumably, a bad debt deduction which is disallowed because it should have been claimed in a prior year will also fall in this category.

129. INT. REV. CODE § 113 (a) (10).

130. In *Elmhirst*, 41 B. T. A. 348 (1940) (N A), decided without benefit of § 115 (1), it was apparently held that the unallowable wash sale loss depleted earnings, but a compensating adjustment was made on sale of the reacquired stock. *Elmhirst*, *supra* at 354.

131. Disallowed by INT. REV. CODE § 24 (a) (4).

132. Not allowable under INT. REV. CODE § 23 (a).

133. Not allowable under INT. REV. CODE § 23 (a) (2) and (q).

134. Disallowed under INT. REV. CODE § 24 (c).

too, deplete the income available for distribution to stockholders and should be deducted in arriving at earnings or profits.¹³⁵

C. Effect of Certain Transactions on Earnings or Profits

Having considered the general nature of earnings or profits and having attempted a reconciliation of the term with taxable net income, there remain for discussion certain transactions which evoke additional problems.

1. Sales or Other Dispositions of Property Acquired Prior to March 1, 1913

As heretofore indicated, new subsections were added to Section 115 of the Code by the Second Revenue Act of 1940. The immediate occasion for the addition of these subsections, (l) and (m),¹³⁶ to the law was the enactment of the 1940 excess-profits tax law. However, they have the effect of not only clarifying the statutory concept of earnings or profits for purposes of determining invested capital, but also of clearing up much of the confusion hitherto connected with the determination of what is a taxable "dividend." The new provisions do not, as is sometimes thought, define earnings or profits, but they do, as stated, eliminate a major part of the uncertainty that surrounded the meaning of that term. Moreover, they are made applicable to all past years.¹³⁷

The language of Section 115 (l) and (m) is forbiddingly complicated. Before it begins to make sense, it must be dissected and each part reread together with the appropriate portions of the committee reports which attempt to explain the statute. There must also be some knowledge of the cases. One of the reasons why the new subsections are so complex is that they carry a double burden: to clarify the meaning of earnings or profits for excess-profits tax purposes, and to clarify that meaning for the purpose of determining whether a distribution is a dividend.¹³⁸ For the first purpose, it matters not whether earnings or profits were accumulated before or after March 1, 1913. But for the second purpose, the dichotomy is sometimes vital for the reason that a distribution out of earnings or profits accumulated after the

135. By way of dictum, the Board in *R. M. Weyerhaeuser*, 33 B. T. A. 594 (1935), states that taxes assessed against local benefits of a kind tending to increase the value of the property assessed (INT. REV. CODE § 23 (c) (4)) also deplete earnings. But this statement overlooks the fact that such taxes are disallowed because they are in the nature of capital expenditures.

136. See INT. REV. CODE § 115 (l) (1) (2), (m) (1) (2).

137. With the exceptions noted note 65 *supra*. There may be some question as to the validity of the retroactive provisions in so far as they affect liabilities of past years.

138. *Ways and Means Committee Report*, H. R. REP. No. 2894, 76th Cong., 3d Sess. (1940) 41.

dividing date is a "dividend," while a distribution out of earnings or profits accumulated before is not a "dividend" but is rather a return of capital to be applied in reduction of basis.

Because, for purposes of determining invested capital, it is not necessary to make any distinction between earnings before and earnings after March 1, 1913, values on that date are of no consequence in determining *total* earnings or profits. Hence, the first subdivision of the first sentence of Section 115 (1) provides, in effect, that for the purpose of computing *total* earnings and profits, the gain or loss on a sale or other disposition¹³⁹ of property (after February 28, 1913) must be computed by using as the amount to be deducted from the proceeds of sale, the adjusted basis¹⁴⁰ for computing gain, without regard to March 1, 1913, value.

The second subdivision of the first sentence of Section 115 (1) comes into play only when the status of a distribution must be determined. It states, in effect, that for the purpose of computing earnings and profits after February 28, 1913, the gain or loss must be determined by using the adjusted basis¹⁴⁰ for determining *gain*. In the case of property acquired prior to March 1, 1913,¹⁴¹ the value of the property on that date, if higher than adjusted cost on that date, will, under all the income tax acts¹⁴² be the basis for computing gain. Thus, the effect of the subdivision is to exclude from post-1913 earnings any pre-1913 increase in value.

To illustrate, suppose a non-depreciable asset cost the corporation \$1,000 prior to 1913, that its value on March 1, 1913, was \$2,000, and that it is sold in 1940 for \$3,000. The taxable gain, based on a 1913 value higher than cost, is only \$1,000, but the true gain on the transaction, ignoring 1913 value, is \$2,000; and subdivision (1) of the first sentence of Section 115 (1) requires the latter amount to be added to aggregate earnings or profits. However, if we wish to determine post-1913 earnings or profits, subdivision (2) compels us to use the 1913 value since that is the basis for computing gain. Accordingly, only \$1,000 of the true gain is included in post-1913 earnings. The remaining \$1,000 constitutes that part of earnings or profits which represents an increase in value prior to February 28, 1913.

139. The examples in the committee reports indicate that the phrase "or other disposition" contemplates depletion and depreciation.

140. Under the law applicable to the year in which the sale or other disposition was made.

141. This does not necessarily include only property actually acquired by the corporation before 1913; the corporation may be entitled or required to use the 1913 value where that constitutes the basis of a transferor.

142. Under current law, INT. REV. CODE § 113 (a) (14), the 1913 value, if higher than cost, may be used only in computing gain; but from 1916 through 1933, it might have been used as a factor in computing gain or loss.

It is the policy of the law to treat pre-1913 increase in value, even if realized, differently from other earnings or profits.¹⁴³ Hence, the \$1,000 referred to at the end of the foregoing illustration must be segregated. This is now accomplished by Section 115 (m) (1) which provides that if any increase¹⁴⁴ in post-1913 earnings "with respect to any matter" would be different had the adjusted basis of the property been determined without regard to its 1913 value, an increase reflecting such difference (with an exception to be mentioned hereinafter) shall be made in that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913. Applying this rule to the illustration given, if 1913 value were ignored the increase in earnings would be \$2,000. The difference, therefore, between this figure and the basis required under 115 (1) (2) is \$1,000 which properly reflects the pre-1913 increase in value.¹⁴⁵

If the application of the rule stated in Section 115 (1) (2) or (m) (1)¹⁴⁶ produces a post-1913 *decrease* in earnings, Section 115 (m) (2) comes into operation. In essence, it provides that if the application of the rules mentioned results in a loss which is to be applied in reduction of post-1913 earnings,¹⁴⁷ such loss shall be reduced by the excess of the adjusted basis used in determining the loss, over the adjusted basis that would be used were 1913 value to be ignored; further, that if such reduction exceeds the loss, the latter excess shall be added to that part of earnings represented by pre-1913 appreciation in value (realized subsequent to February 28, 1913).

That the statutory convolutions produce correct results will be apparent from the following table showing the application of the rules contained in Section 115 (m) and the first sentence of Section 115 (1) to all of the possible variations involved (under current law) in a sale of property acquired prior to March 1, 1913:

143. See p. 871 *supra*.

144. INT. REV. CODE § 115 (m) (1) reads "increase or decrease." However, if a decrease results from a sale or other disposition, § 115 (m) (1) does not apply; § 115 (m) (2), discussed in the succeeding paragraph of the text, comes into operation. Hence, the word "decrease" in § 115 (m) (1), taken together with the subsequent phrase "with respect to any matter," presumably contemplates depletion or depreciation. The phrase "or any other disposition" is apparently also intended to cover depletion and depreciation. See note 139 *infra*.

145. Another illustration is contained in U. S. Treas. Reg. 103, § 19.115-14, Example (1). The same section, Example (2), contains an illustration involving *depreciable* property.

146. See note 144 *supra*.

147. The statutory phrase is "earnings and profits for any period beginning after February 28, 1913." A transaction by a corporation reporting for the calendar year 1913 would thus be excluded.

	^a Cost (adjusted to Mar. 1, 1913)	^b March 1, 1913 value	^c Proceeds of sale	^d Gain or Loss for income tax purposes	^e Effect on total earnings or profits Sec. 115 (1) (1)	^f Effect on earn- ings or profits after Feb. 28, 1913, Sec. 115 (1) (2)	^g Earnings and profits con- sisting of increase in value accrued prior to Mar. 1, 1913, Sec. 115 (m) (1)
1.	1,000	1,200	1,500	300	500	300	200
2.	1,000	800	600	(400)	(400)	(400)	None
3.	1,000	800	1,500	500	500	500	None
4.	1,000	800	900	(100)	(100)	(100)	None
—	—	—	—	—	—	Sec. 115 (m) (2)	Sec. 115 (m) (2)
5.	1,000	1,200	800	(200)	(200)	(200)*	None
6.	1,000	1,200	1,100	None	100	None**	100

Parentheses indicate losses. The table assumes that the property in question is not subject to depreciation or other adjustment after 1913.

It will be noted that columns f and g add up to column e and that columns d and f are always the same.

*Sec. 115 (1) (2) would have produced a loss of \$400.

**Sec. 115 (1) (2) would have produced a loss of \$100.

2. Tax-free Exchanges Generally

The second sentence of Section 115 (1) provides that realized gain or loss on a sale or other disposition of property "shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made." The *raison d'être* of this provision is found in a series of Board and court cases of which *McKinney v. Commissioner*,¹⁴⁸ and *F. J. Young Corp. v. Commissioner*,¹⁴⁹ are the leading ones.¹⁵⁰ In these decisions¹⁵¹ which involved the status of corporate distributions, the Board and the courts rejected the position taken by the Treasury (now enacted into law) to the effect that gains and losses from a sale or other disposition of property enter into earnings or profits only to the extent that such gains or losses were rec-

148. 32 B. T. A. 450 (1935), *aff'd*, 87 F. (2d) 811 (C. C. A. 10th, 1937).

149. 35 B. T. A. 860 (1937), *aff'd*, 103 F. (2d) 137 (C. C. A. 3d, 1939).

150. Other cases in the series: *Dorothy W. Elmhirst*, 41 B. T. A. 348 (1940) (N. A.), appeal now pending before the Second Circuit Court of Appeals; *W. S. Farish*, 38 B. T. A. 150 (1938), *aff'd*, 104 F. (2d) 833 (C. C. A. 5th, 1939); *Helen Sperry Lea*, 35 B. T. A. 243 (1937), *rev'd on other grounds*, 96 F. (2d) 55 (C. C. A. 2d, 1938); *Robert McCormick, Executor*, 33 B. T. A. 1046 (1936); *Susan T. Freshman*, 33 B. T. A. 394 (1935); *National Grocer Co.*, 1 B. T. A. 688 (1925). The last named was an excess-profits tax case. In the *Lea* and *McCormick* cases, the point involved was merely by way of dictum.

151. The cases are subjected to a critical analysis in PAUL, *op. cit. supra* note 84, at 157-158 n., 187-189.

ognized under the provisions of sections corresponding to Section 112 of the Code.¹⁵² According to the Treasury, a transaction which resulted in a realized gain or loss did not affect earnings or profits if that gain or loss was not recognized because of Section 112.

The *McKinney* case did not, in the technical sense, involve a gain or loss from a sale or other disposition of property. It was concerned, rather, with the amount of depletion to be deducted in ascertaining earnings. The depletable property, an oil and gas lease, had been acquired by the corporation from its sole stockholder, Ida McKinney, in exchange for all of its capital stock, in a transaction which was wholly tax-free under a provision of the 1924 Act corresponding to Section 112 (b) (5) of the Code. The basis of the depletable property to the transferor, Ida McKinney, was approximately \$28,800, while its value at the time of acquisition by the corporation was \$247,500. In computing the corporation's taxable net income, the appropriate basis for calculating depletion was \$28,800¹⁵³ (the basis of the transferor). But, claimed the stockholder, for the purpose of determining earnings, the appropriate basis for calculating depletion was \$247,500. She rested this argument largely upon the ground that Treasury Regulations of long standing provided, that a distribution out of a depletion reserve based upon *cost*¹⁵⁴ was not out of earnings. Cost, she asserted, meant cost to the corporation and not cost to the transferor. Both the Board and the appellate court accepted this argument, with the result that earnings were reduced by a larger amount of depletion, and a smaller percentage of the distribution became taxable. While the conclusion reached in the *McKinney* case has the support of logic, the practical result is undesirable since it would permit escape from high surtax rates of *distributed* income which, but for the interposition of the corporation, would be subject to such rates. In any event, the effect of the decision has been nullified by the second sentence of Section 115 (1). It is true that this sentence refers to a gain or loss on the sale or other disposition of property and a depletion deduction would not ordinarily be treated as falling within this phrase, but the committee reports make it plain that the *McKinney* case was one of the situations at which the statute was aimed.¹⁵⁵

152. The Treasury's position was first clearly articulated in the regulations issued under the 1934 Act. U. S. Treas. Reg. 86, Art. 115-1. This was subsequent to the years involved in the *McKinney* and *Young* cases. In the *Freshman* case, the Commissioner took an opposite position.

153. Except that percentage depletion might have been deducted.

154. The Regulations now provide that where the property is acquired after 1913, the only depletion to be considered in ascertaining earnings is depletion based on cost or other basis. U. S. Treas. Reg. 103, § 19.115-3.

155. *Senate Finance Committee Report*, SEN. REP. No. 2114, 76th Cong., 3d. Sess. (1940) 24: "The subsection applies regardless of the form taken by the sale or

The *Young Corporation* case is also overturned by the second sentence of Section 115 (1). In that case, the distributing corporation (Yeager) had participated in a tax-free exchange. It had surrendered property which had a cost and basis to it of \$36,000 and had received in exchange stock of another corporation (Empire) worth \$957,000. This exchange was tax-free under Section 112 (b) (5) of the 1928 Act; hence the gain of \$921,000 was not recognized. The Yeager Corporation distributed the Empire stock, and some other securities which it owned, to its stockholders, of whom the Young Corporation was one. The earnings of Yeager, apart from the unrecognized gain, were not sufficient to cover the total value of the distribution; and hence the Commissioner asserted that the distribution was a "dividend" only to the extent of such earnings, the balance being applied in reduction of basis of the Yeager stock, and that to the extent of the excess over such basis it was taxable. (The distributee in this case was a corporation which wanted the distribution treated in full as a "dividend," since intercorporate dividends were then fully exempt.) As heretofore indicated, the Board and the appellate court rejected the Commissioner's argument and held that the gain on tax-free exchanges became part of earnings, even though such gain was not recognized in the determination of taxable net income.

Although the decisions in the *Young* and allied cases achieve what is, in the eyes of many, a desirable economic result, they have been persuasively criticized as contravening Congressional intent.¹⁵⁶ Any doubt that the decisions do not accord with present intent is removed by the additions to Section 115 made by the Second Revenue Act of 1940 and by the committee reports explaining such additions.¹⁵⁷

The second sentence of Section 115 (1) is, of course, applicable not only to tax-free exchanges of the type involved in the cases just discussed, but to all exchanges in which neither gain (whether in whole or in part) nor loss is recognized.¹⁵⁸ Thus, referring to Example 1 under the preceding heading,¹⁵⁹ if we assume that the property, let us say land, was condemned, and that the condemnation proceeds amounted to \$1,500, of which \$1,400 was invested in other land pur-

other disposition . . ." The example which follows this statement contains virtually the exact facts of the *McKinney* case. The Treasury Regulations contain the same example. U. S. Treas. Reg. 103, § 19.115-3.

156. PAUL, *op. cit. supra* note 84, at 191-199.

157. *Ways and Means Committee Report*, H. R. REP. No. 2894, 76th Cong., 3d. Sess. (1940) 40; *Finance Committee Report*, SEN. REP. No. 2114, 76th Cong., 3d. Sess. (1940) 23-24; *Conference Report*, H. R. REP. No. 3002, 76th Cong., 3d. Sess. (1940) 60. See also U. S. Treas. Reg. 103, § 19.115-12, first Example (1) which is based on the facts of the *Young* case.

158. It would also apply to instalment sales so as to spread the gain pursuant to § 44.

159. See p. 892 *supra*.

suant to the provisions of Section 112 (f) of the Code, the result will be that only the *recognized* gain of \$100, i. e., the unexpended proceeds, will enter into total earnings and into earnings ascribed to pre-1913 increase in value. Similarly, in Example 2, if the \$600 proceeds represented the value of property received in an exchange the loss on which was not recognized under Section 112, the realized loss of \$400 would not deplete earnings.¹⁶⁰

3. Tax-free Reorganizations

Suppose *A* Corporation which has accumulated earnings of \$100,000 transfers all of its assets to *B* Corporation, a newly organized company in a tax-free reorganization. *B* assumes *A*'s liabilities and issues *B*'s stock to the *A* stockholders in exchange for their *A* stock. *A* is dissolved. Thereafter, *B* having neither made any profits nor suffered any losses, makes a distribution of \$50,000, charging it against paid-in surplus set up on *B*'s books at the time of taking over the *A* assets. Is the \$50,000 a "dividend"?

The answer is yes. However, the solution is not the result of any specific statutory provision, but rather of judicial development. The statute, Section 115 (a), defines a dividend as any distribution by a corporation to its shareholders out of *its* earnings, and, viewing *B* as a separate juristic entity, it is difficult to say that *B* has distributed *its* earnings, for it has none. Nevertheless, the courts have held that the earnings of the predecessor became earnings of the successor, a conclusion which is justifiable in view of the fact that a contrary rule would have imputed to Congress an intent to permit a simple reorganization of the type described above to impede tax on the distribution of earnings—an intent opposite to that which it obviously had. The rule, known as the *Sansome* doctrine, was first enunciated in the case of that name,¹⁶¹ and is expressed by Judge Learned Hand as follows:

" . . . a corporate reorganization which results in no gain or loss under section [112 of the present law] does not toll the company's life as a continued venture under section [115 of the present law], and . . . what were 'earnings or profits' of the

160. For further examples see U. S. Treas. Reg. 103, § 19.115-12.

161. *Commissioner v. Sansome*, 60 F. (2d) 931 (C. C. A. 2d, 1932), *reversing* 22 B. T. A. 1171. The facts of the *Sansome* case are substantially the same as those in the hypothetical case in the text. The *Sansome* case involved a *liquidating* dividend which, under the 1921 Act, was taxable as an ordinary dividend to the extent of the corporation's earnings. In *United States v. Kauffmann*, 62 F. (2d) 1045 (C. C. A. 9th, 1933), the rule was applied to a non-liquidating dividend under the 1924 Act. The doctrine is now taken for granted. See 1940 H. R. REP., *supra* note 157 at 41, SEN. REP., *supra* note 157 at 25, and note § 718 (b) (3) of the Code relating to excess-profits tax.

original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent . . ." ¹⁶³

The doctrine has been extended to more complicated tax-free reorganizations.¹⁶⁵ Thus, in *Baker v. Commissioner*,¹⁶⁴ where a parent corporation consolidated five wholly owned subsidiaries into a new company, the earnings of the new consolidated company immediately after the consolidation consisted of the aggregate earnings of the five old companies. And in *Helen V. Crocker*,¹⁶⁵ it was ruled that the doctrine was applicable where a new corporation acquired the assets of three old corporations which apparently had different stockholders. In *Barnes v. United States*,¹⁶⁶ where the transferring corporation transferred only 60% of its net assets to the transferee corporation, it was held that 60% of the transferor's earnings were projected into the transferee.¹⁶⁷

Although there are no cases in point, cold logic would compel the application of the same rule to deficits.¹⁶⁸ But logic is an undependable tool. Suppose *B* Corporation, which has accumulated earnings, takes over all the assets and liabilities of *A* Corporation, which has an operating deficit equal to or greater than *B*'s earnings. (Or suppose *B* had the deficit and *A* had the earnings.) Does this completely eliminate the earnings of *B* (or *A*) so that a distribution by it would not be a "dividend"? Consistency would compel the conclusion that it does. Yet, such consistency may produce an absurd result and if it does, the doctrine in such a situation is not likely to be invoked.

The foregoing discussion considers the effect on earnings of a tax-free reorganization from the viewpoint of the corporation which acquires assets in the reorganization without surrendering anything other than its stock or securities. But the corporation which transfers

162. 60 F. (2d) 931, 933 (C. C. A. 2d, 1932).

163. The *Sansome* doctrine does not operate to make the earnings of a subsidiary the earnings of the parent prior to distribution by the subsidiary. *Harter*, 30 B. T. A. 572 (1934), reversed on other grounds, 79 F. (2d) 12 (C. C. A. 2d, 1935); *James*, 13 B. T. A. 764 (1928). A 1938 amendment to § 115 (h) made it clear that on a tax-free liquidation of a subsidiary under § 112 (b) (6), the liquidating distributions to the parent do not deplete the subsidiary's earnings which carry over to the parent. *Senate Finance Committee Report*, SEN. REP. No. 1567, 75th Cong., 3d Sess. (1938) 18-19.

164. 80 F. (2d) 813 (C. C. A. 2d, 1936), affirming 28 B. T. A. 704. To the same effect: *Coudon v. Tait*, 61 F. (2d) 904 (C. C. A. 4th, 1932).

165. 29 B. T. A. 773 (1934). Five members dissented. The majority opinion, by way of dictum, states that if the net result of the pooling of the old corporations' surpluses was a surplus, the fact that some of them might have had deficits would not have prevented the distribution from being treated as a "dividend."

166. 22 F. Supp. 282 (Pa., 1938).

167. In *Murchison's Estate v. Commissioner*, 76 F. (2d) 641 (1935), there appeared to be a transfer to two new corporations, one of which made the distribution in question. Presumably, the pro-rata portion of the old corporation's earnings passing to the distributing corporation, exceeded the distribution.

168. See note 176 *supra*.

assets in a reorganization may also have a problem. *A fortiori*, any earnings of the transferring corporation which are transmuted into earnings of the acquiring company, cease to be earnings of the former. Thus, in the *Barnes* case, it would presumably be ruled that 40% of the transferring company's earnings remained with it. Where the transferring corporation acquires "boot" in a Section 112 (d) transaction and retains the "boot," the gain on the exchange will be taxable to the extent of that "boot"¹⁶⁹ and only to that extent will it become part of earnings. If the "boot" is distributed to stockholders, so that no part of the gain is taxable,¹⁷⁰ it is now clear, by virtue of the second sentence of Section 115 (1), that the unrecognized gain will not become part of earnings.¹⁷¹

There remains for consideration under this heading the case of a tax-free reorganization which is merely a recapitalization.¹⁷² This is covered by Section 115 (h)¹⁷³ which provides *inter alia* that a distribution of the corporation's securities shall not be considered a distribution of earnings if no gain was recognized to the distributee on the receipt of such securities. Thus, if A Corporation in a tax-free recapitalization issues preferred and common stock in exchange for common,¹⁷⁴ even if the exchange has the effect of capitalizing part of the company's earnings so far as its books are concerned, there is no diminution of earnings or profits.

4. Distributions in Stock of the Distributing Corporation (Stock Dividends)¹⁷⁵

Ever since the modern income tax era began, the taxation of stock dividends has been a controversial storm center. This is not the place to explore the subject, but we have to recognize that the question is by no means finally settled.¹⁷⁶ Under Section 115 (f) (1), the only stock dividend which is exempt from tax is one which is constitutionally immune. Apparently the only kind of stock dividend which stands a

169. INT. REV. CODE § 112 (d) (2). The term "boot" comprises money or property which may not be received tax-free.

170. INT. REV. CODE § 112 (d) (1).

171. Under § 112 (c) (2), where a stockholder receives "boot" in a reorganization, that part of his gain represented by the "boot" may be taxable to him as a dividend up to the amount of his ratable share of the corporation's earnings. But, as indicated in the text, "boot" received by a corporation and distributed to its stockholders does not become part of earnings.

172. § 112 (g) (1) (E).

173. Similar provisions have been contained in the revenue acts since 1924. E. g. § 203 (g) of the 1924 Act.

174. For an example of such a recapitalization, see Hartzell, 40 B. T. A. 492 (1939) (A).

175. In the ensuing discussion, the term "stock dividend" should be understood to include rights to buy additional stock of the distributing corporation.

176. See note 109 *supra*.

chance of falling within this category is common on common.¹⁷⁷ Even as to the latter type, there may be a question where both voting and non-voting common are involved,¹⁷⁸ apart from the now dubious authority of *Eisner v. Macomber*.¹⁷⁹ Pending the ultimate settlement of the question, all that can be done, so far as ascertainment of earnings or profits is concerned, is to state that a stock dividend which is exempt does not deplete earnings, while one which is not exempt, does. Obviously, a stock dividend which is not treated as a "dividend" for income tax purposes should not exhaust earnings so as to make future cash distributions returns of capital. Section 115 (h), mentioned in the last paragraph of the preceding heading, makes it plain that an exempt stock dividend does not deplete earnings.¹⁸⁰ It contains a provision to the effect that a distribution which is constitutionally exempt shall not be considered a distribution of earnings. It also provides that any distribution which was exempt under Section 115 (f) of the 1934 Act or a corresponding provision of a prior act shall not be considered a distribution of earnings. Section 115 (f) of the 1934 Act specifically exempted *all* stock dividends, as did the prior acts from 1921 on. Accordingly, any distribution of a stock dividend from 1921 through 1935 did not reduce earnings available for future distribution.¹⁸¹

Where one corporation receives a non-taxable stock dividend from another corporation, the distribution does not become part of the earnings of the first corporation. This is made plain by subdivision two of the fourth sentence of Section 115 (1).¹⁸²

5. Effect of Distributions in Partial Liquidation

A Corporation begins operating with an original capital of \$200,000.¹⁸³ By 1940 it has accumulated earnings of \$100,000. In 1940 it redeems half of its stock against a cash payment of \$150,000. On

177. *Helvering v. Gowran*, 302 U. S. 238 (1937); *Koshland v. Helvering*, 298 U. S. 441 (1935); *Eisner v. Macomber*, 252 U. S. 189 (1920); *Kelly Trust*, 38 B. T. A. 1014 (1938).

178. *Keister*, 42 B. T. A. 484 (1940). It may be possible to achieve the effect of a stock dividend, without tax, by means of a tax-free recapitalization under § 112 (g) (1) (E).

179. 252 U. S. 189 (1920), cited note 109 *supra*.

180. Even before, the statute contained a specific provision, it was held that exempt stock dividends did not reduce earnings. *Walker v. Hopkins*, 12 F. (2d) 262 (C. C. A. 5th, 1926); *H. Y. McCord*, 31 B. T. A. 338 (1934); *Hugh R. Wilson*, 3 B. T. A. 957 (1926).

181. Section 115 (h) also affects certain distributions, under § 112 (g) of the 1932 Act and corresponding provisions of earlier acts back to and including 1924, of securities in connection with a reorganization, which were tax-free when made, but which would not be tax-free under existing law. Section 115 (h) makes it clear that such tax-free distributions did not constitute distributions of earnings.

182. In the case of non-taxable stock dividends received prior to 1936, this rule would apply only if an allocation of the basis of the old stock between the old and the new is required. See U. S. Treas. Reg. 103, § 19.115-13, Example (2).

183. It would make no difference whether this were all credited to capital stock or part to stock and part to paid-in surplus.

January 2, 1941, it makes a distribution of \$10,000. Assuming that there are no earnings for the entire year 1941, is the distribution of January 2 a "dividend"? The solution to this question turns upon the effect on earnings of the 1940 redemption. In the absence of an impeding provision, a plausible argument might be made that since "every distribution is made out of earnings or profits to the extent thereof,"¹⁸⁴ the distribution made in partial liquidation¹⁸⁵ in 1940 more than exhausted the earnings so that the 1941 distribution was out of some other source. However, any basis for such an argument is destroyed by the penultimate sentence of Section 115 which provides:

"In the case of amounts distributed . . . in partial liquidation¹⁸⁶ . . . the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits."

In the illustration given, half of the stock has been redeemed, hence the original capital should be reduced by half. This amounts to \$100,000, leaving \$50,000 of the 1940 distribution to be charged against earnings. This procedure still leaves \$50,000 in the earnings account, which would be more than sufficient to cover the 1941 distribution, so that the latter is a dividend.

In *Foster v. United States*,¹⁸⁷ it was held that the March 1, 1913 earnings and increase in value before that date of a corporation are "capital" within the meaning of Section 115 (c). In the *Foster* case a portion of the company's stock was redeemed on October 10, 1929, for exactly its March 1, 1913, value (\$1,025,000) which was far in excess of the original capital applicable to such stock (\$50,000). The recipient of a subsequent distribution on February 11, 1930, contended that the amount properly chargeable to capital with respect to the redemption was only \$50,000 and that the remaining \$975,000 was chargeable to the most recently accumulated earnings. Post-1913 earnings were less than \$975,000. Hence, it was claimed that such earnings were exhausted and that the subsequent distribution was a "dividend" only to the extent of the earnings between October 10, 1929, and February 11, 1930.¹⁸⁸ The Court rejected this argument and ruled that the plain purpose of Congress in enacting Section 115 (c) was to prevent

184. INT. REV. CODE § 115 (b).

185. INT. REV. CODE § 115 (i) defines "amounts distributed in partial liquidation" as a distribution "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."

186. Here follows "(other than a distribution to which the provisions of subsection (h) of this section are applicable)." A corresponding provision has been in the law since 1924. SEIDMAN, *op. cit. supra* note 25, at 678.

187. 303 U. S. 118 (1938).

188. As pointed out on p. 874 *supra*, an excess of distributions over earnings does not operate to deplete future earnings.

escape from tax on post-1913 earnings, and that the accumulated earnings and appreciation in value to March 1, 1913, were deemed to be capital from the viewpoint of the corporation.¹⁸⁹

A very recent application of the Section 115 (c) provision now under review is found in *William D. P. Jarvis*,¹⁹⁰ where the Board refused to extend the theory of the *Foster* case to post-1913 earnings and ruled that such earnings were not capital within the meaning of the provision. In the *Jarvis* case, the corporation had been organized after 1913 with a capital stock of \$1,000,000 and a paid-in surplus of \$911,500. In 1934, it purchased and subsequently retired one-tenth of its total capital stock for \$1,160,000. The Board ruled that of this distribution, \$100,000 was chargeable to capital stock and \$91,150 was chargeable to paid-in surplus; the remainder of the \$1,160,000 was chargeable to earnings to the extent thereof. The earnings at the time of acquisition of the stock were not sufficient to absorb the entire excess over the charge to capital and surplus. Hence, a subsequent distribution in 1935 was held taxable as a dividend only to the extent of the earnings subsequent to the 1934 distribution,¹⁹¹ the balance of the 1935 distribution being chargeable to capital account.¹⁹²

A redemption of stock which is ruled to be essentially the equivalent of a dividend under Section 115 (g) should, of course, lessen earnings. Despite the fact that such a redemption would fall within the definition of "partial liquidation" contained in Section 115 (i), the obvious intent of the statute would be defeated if any portion of the redemption were charged to capital.

6. Transactions in Treasury Stock

Like the question of stock dividends, the appropriate income tax treatment of dealings by a corporation in its own stock is still in flux. *Helvering v. Reynolds Tobacco Co.*,¹⁹³ relying on the unrealistic and unstable doctrine that legislative re-enactment in the face of administrative construction confers authoritative sanction on the administrative interpretation, merely held that where a corporation bought

189. Cf. the *Canfield* case, and *Lynch v. Hornby*, 247 U. S. 339 (1918), which hold that the pre-1913 earnings and increase in value are *not* frozen into capital so far as the stockholder is concerned.

190. 43 B. T. A. No. 58, Jan. 29, 1941.

191. See note 188 *supra*.

192. Cf. *Harter v. Helvering*, 79 F. (2d) 12 (C. C. A. 2d, 1935) and *August Horrmann*, 34 B. T. A. 1178 (1936), which the Board properly regards (in the *Jarvis* case) as overruled in part by the *Foster* decision. In both these cases, the company was organized prior to 1913 and under the rule of the *Foster* case, redemptions should have been charged first to pre-1913 earnings (which had become "capital" so far as § 115 (c) was concerned), rather than to post-1913 earnings. Where a non-taxable stock dividend is issued, the original capital is apparently spread over the original stock and the stock dividend in proportion to the values of each. *August Horrmann supra*.

193. 306 U. S. 110 (1939).

and sold its own stock prior to 1934, no gain or loss arose. Up to May 2, 1934, the Treasury Regulations had held that there was no gain or loss to a corporation on the purchase or sale of its own stock, and the Court simply ruled that the 1934 amendment to the regulations purporting to make such gains and losses taxable and deductible could not be made retroactive.¹⁹⁴ Despite extensions by the lower tribunals¹⁹⁵ of the result in the *Reynolds* case to sales of treasury stock after the date of the amendment to the regulations, it can not be considered finally settled that a gain or loss on a sale of treasury stock after the amendment date is to be excluded in fixing taxable net income. Nor is it likely that the Court meant to overrule a case such as *Commissioner v. Woods Machine Co.*¹⁹⁶ in which the corporation received its own stock in settlement of a claim for patent infringement and was required to include the value of the stock in taxable income.

Pending a solution of the problems which still cluster around transactions involving treasury stock, no clear cut statement of the effect of such transactions on earnings can be made. However, it seems plain that if gains and losses on treasury stock transactions are ultimately ruled to be components of taxable income, earnings should be correspondingly affected. Even if such gains or losses are excluded from taxable net income, there seems to be no persuasive reason why they should not add to or detract from earnings. If a corporation buys its stock at 10 and sells at 20, it has made a clear profit of 10. It would be fatuous to blind ourselves to the fact that the accession has increased the amount available for distribution to its stockholders. Conversely, if it sold for 5 the resulting loss would patently have depleted the amount available for distribution. Dealings in treasury stock, if gain or loss is not taxable or allowable, stand on a different footing from tax-free exchanges. The unrecognized gain or loss on the latter is postponed (except where the property received in the exchange is never sold or exhausted), whereas there is no deferment of a gain or loss on a sale of treasury stock.¹⁹⁷ Unless earnings

194. See PAUL, *STUDIES IN FEDERAL TAXATION* (3d Ser. 1940) 420; Alvord, *Treasury Regulations and the Wilshire Oil Case* (1940) 40 COL. L. REV. 252; Brown, *Regulations, Revocation and the Revenue Acts* (1941) 54 HARV. L. REV. 377; Griswold, *A Summary of the Regulations Problem* (1941) 54 HARV. L. REV. 398; Surrey, *The Scope and Effect of Treasury Regulations* (1940) 83 U. OF PA. L. REV. 556.

195. In *National Home Owners Service Corp.*, 39 B. T. A. 753 (1939) (N A) the Board refused to apply the amended regulation under the 1934 Act; and in *National Manufacturing & Stores Corp. v. Allen*, Prentice Hall, 1940 Fed. Tax Serv. ¶62,932 (D. C. Ga.) the court held that the earlier regulation had become embedded in the statute and could not be changed even as to future years. It is hard to see how a change in an interpretative regulation, as distinguished from a legislative regulation such as that involved in *Helvering v. Wilshire Oil Co.*, 308 U. S. 90 (1939), can have the effect of making the same statutory language mean one thing one day and another the next day.

196. 57 F. (2d) 635 (C. C. A. 1st, 1932), cert. denied, 287 U. S. 613 (1932).

197. A gain on the sale of treasury stock, if not taxable, is excluded under an administrative interpretation of § 22 (a) (defining gross income) rather than by virtue of any provision of § 112.

are affected at the time of sale of the treasury stock, they will never be affected. Accordingly, the sounder position seems to be that gains or losses on treasury stock, even if excluded from taxable net income, should increase or decrease earnings.

The above discussion assumes that the mere acquisition of treasury stock is not itself a distribution; and it has been so held.¹⁹⁸ The new excess-profits tax regulations¹⁹⁹ also assume that the mere acquisition of treasury stock does not affect earnings or profits. However, if the treasury stock is ultimately retired, it then becomes necessary to make an appropriate adjustment to earnings.²⁰⁰

7. Distributions in Kind

It has consistently been held that unrealized increase or decrease in value of property does not increase or lessen earnings or profits.²⁰¹ Suppose *A* Corporation has invested \$10,000 in stock of *B* Corporation. It distributes this stock to its (*A*'s) stockholders at a time when the stock is worth \$100,000. Does the distribution effect a "realization" of the \$90,000 enhancement in value? If the distribution is one in complete or partial liquidation, there is no realization to the corporation in the income tax sense. The Treasury Regulations have uniformly held that "no gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition";²⁰² and if the doctrine of legislative re-enactment has any vitality at all, surely this provision must be embedded in the law.

A fortiori, the same rule should apply to a distribution in kind which is not in partial or complete liquidation. This conclusion seems almost inescapable in view of the fact that Section 115 (d) contemplates tax-free distributions out of unrealized post-1913 increase in

198. William A. Smith, 38 B. T. A. 317 (1938); cf. John B. Stewart, 29 B. T. A. 809 (1934). In the *Stewart* case, an acquisition of treasury stock followed by issuance of the stock to the remaining stockholders as a stock dividend was held to be out of earnings, except for the amount chargeable to capital. (Three members dissented.) To the extent that the distribution was ruled out of post-1913 earnings rather than pre-1913 earnings, the case is considered overruled by the *Foster* case. See Jarvis, 43 B. T. A. No. 58, Jan. 29, 1941.

199. U. S. Treas. Reg. 109, §§ 30.718-4 and 30.720-1. See also U. S. Treas. Reg. 103, § 19.27 (d)-1; and Treas. Reg. 64, Art. 47 (a) (Capital Stock Tax). See also *Diamond Alkali Co. v. Driscoll*, Prentice-Hall 1941 Fed. Tax Serv. ¶ 62,475 (W. D. Pa. 1941).

200. U. S. Treas. Reg. 109, § 30.718-4.

201. See p. 878 *supra*. Note also the following statement from the *Senate Finance Committee Report on the Second Revenue Act of 1940*, SEN. REP. NO. 2114, 76th Cong., 3d Sess. (1940) 25: "Of course, mere increase or decrease in value (after February 28, 1913) of property owned by a corporation does not increase [sic] its earnings and profits."

202. U. S. Treas. Reg. 103, § 19.22 (a)-21. All prior regulations back as far as 1918 contained similar provisions, e. g., Art. 547, Reg. 45 (1918 Act). An exception is the distribution of an instalment obligation; § 44 (d) of the Code.

value;²⁰³ and if distribution effects realization, it would be impossible to make a distribution out of unrealized post-1913 appreciation. This conclusion is further fortified by the result in *General Utilities & Operating Co. v. Helvering*.²⁰⁴ The Government, before the Supreme Court, argued in that case that where a corporation pays a dividend in property which has appreciated in value, it realizes gain.²⁰⁵ The Court, in deciding the case against the Government, partly on procedural grounds, did not specifically allude to this argument, but at the same time it said: "Both tribunals below rightfully decided that [the distributing corporation] received no taxable gain from the distribution among its stockholders of the [appreciated property] as a dividend. This was no sale; assets were not used to discharge indebtedness."²⁰⁶

8. Effect of Consolidated Returns²⁰⁷

Space limitations preclude any detailed discussion of the effect of a consolidated return on the earnings status of either the consolidated group or of the component companies. To illustrate the type of problem that may be encountered, suppose Subsidiary A sells property to Subsidiary B for cash during a consolidated return period. The gain or loss on the sale is not recognized in determining taxable net income and should not, therefore, affect the earnings of Subsidiary A [Section 115 (1)]. The unrecognized gain or loss will be picked up by Subsidiary B if and when that corporation sells to an outsider, whether or not the sale to the outsider occurs during a consolidated return period [Section 113 (a) (11)]. This result is somewhat akin to an application of the *Sansome* rule, except that the transferred earnings (or loss), so far as the transferee is concerned, remain potential rather than crystallized. Viewing the participating corpora-

203. See p. 871 *supra*; *Report of Ways and Means Committee on 1924 Act*, H. R. REP. No. 179, 68th Cong., 1st Sess. (1924) 12.

204. 296 U. S. 200 (1935).

205. In the lower tribunals, the Government had maintained that the corporation had declared a dividend payable in a specific amount of dollars and cents and had subsequently effected payment of the dividend with property worth far more than its cost, so that the transaction was the equivalent of a sale resulting in taxable gain. The Government had conceded, in the lower tribunals, the distinction between a dividend of the kind just mentioned and a dividend declared to be payable in kind. PAUL, *op. cit. supra*, note 84, at 171.

206. Cf. *Binzel v. Commissioner*, 75 F. (2d) 989 (C. C. A. 2d, 1935), which is rightly characterized as a "fuzzy" decision in PAUL, *op. cit. supra*, note 84, at 174. In the *Binzel* case it was apparently taken for granted that a distribution in appreciated property did not realize taxable profit to the distributing corporation, but the enhancement in value was nevertheless taxed to the stockholders as a dividend in the absence of a showing that the post-1913 earnings were insufficient to absorb the enhanced value of the distributed property.

207. Under current law, only railroad corporations and certain Pan-American trade corporations may file consolidated income tax returns. However, for *excess-profits* tax purposes, any affiliated (as defined in the statute) group of corporations is permitted to file a consolidated return.

tions as distinctly separate entities, seemingly incongruous results may develop, but the aggregate result will be correct.

It has been held, without conflict, that the earnings of a subsidiary do not become earnings of the parent corporation prior to distribution by the subsidiary.²⁰⁸ For purposes of determining the status of a distribution, this rule may possibly be waived if a consolidated return is filed by the two corporations.²⁰⁹

9. Distributions to Shareholders Who Reported Pro-rata Shares of Income in Prior Years

Under certain provisions of current and prior laws,²¹⁰ stockholders have been permitted²¹¹ to save their corporations from certain taxes by including in their individual returns their pro-rata portions of the corporation's net income. In such situations, the earnings and profits included in the income so reported may be withdrawn as returns of capital, provided all subsequent earnings and profits are first exhausted.²¹² Earnings so reported and left in the corporation will be subject to depletion by a subsequent loss;²¹³ so that distributions after the loss year may have to be applied against earnings of the period prior to the years for which the stockholders have reported their pro-rata shares.²¹⁴

V. CONCLUSION

1. The second clause of Section 115 (a) of the Code, which adds to the definition of a "dividend" any distribution out of the earnings of the taxable year without regard to the aggregate earnings, should

208. Arthur C. James, 13 B. T. A. 764 (1928), *aff'd*, 49 F. (2d) 707 (C. C. A. 2d, 1931); Harter, 30 B. T. A. 572 (1934), *reversed on other grounds*, 79 F. (2d) 12 (C. C. A. 2d, 1935).

209. Thus, in *Merrick v. United States*, Prentice-Hall 1940 Tax Serv. ¶ 62,482, it was stipulated by the taxpayer and the Government that if one of the subsidiaries had sustained a bad debt deduction, the distribution in question was not "out of the consolidated earnings of [the parent] and its subsidiaries." Cf. U. S. Treas. Reg. 110, § 33-31 (a) (20) (relating to consolidated excess profits tax returns), which provides that the consolidated earnings at the beginning of the year shall be the excess of the combined earnings of the constituent companies having earnings over the combined deficit of the deficit companies.

210. E. g. § 725 (b) and Supplement S of Chapter 1 of the Code (personal service corporations); § 351 (d) of the 1936 Act (personal holding companies); § 102 (d) of the 1936 Act (unreasonable accumulation of surplus); § 28 of the 1938 Act (consent dividends credit).

211. In some cases, the stockholders have been *required* to include in their individual returns, their pro-rata shares of the corporation's net income; e. g., § 218 of the 1918 Act. Cf. § 337 (e) of the Code (foreign personal holding companies).

212. See INT. REV. CODE § 115 (e); I. T. 3295, 1939-2, CUM. BULL. 243. The subsequent earnings must first be exhausted because of the presumption contained in § 115 (b) to the effect that all distributions are out of the *most recently accumulated* earnings.

213. See p. 875 *supra*, and Dorothy W. Elmhirst, 41 B. T. A. 348 (1940).

214. Dorothy W. Elmhirst, 41 B. T. A. 348 (1940).

be deleted. The undistributed profits tax which begot the clause is now relegated to limbo, so that the clause itself is now anachronistic.²¹⁵ As a matter of fairness, a stockholder should not be required to treat as a "dividend" what is obviously a return of capital. This is exactly what occurs where a corporation which has an accumulated aggregate deficit makes a distribution in a year when it happens to have some earnings. Moreover, since a postponement of the distribution to a year in which there were no earnings, assuming the continuance of an aggregate deficit, would convert the distribution from a "dividend" into a return of capital, there is no reason to penalize an acceleration of the distribution.

2. The exclusion from the definition of "dividends" of distributions out of pre-1913 earnings has no sound foundation and the definition should be changed to make a distribution out of *any* earnings taxable as a "dividend." The exemption of pre-1913 earnings was prompted, at least in part, by a mistaken conception by the Congress of its constitutional powers.²¹⁶ The House has thrice voted to repeal the exemption, advancing adequate reasons therefor in its Ways and Means Committee Reports;²¹⁷ but each time a recalcitrant Senate, without giving any reason other than that the provision had been in the law for many years,²¹⁸ has blocked reform.

In the case of a stockholder who acquired his stock prior to March 1, 1913, a plausible argument might be made in support of the exemption of distributions out of pre-1913 earnings on the ground that it is the policy of the law to permit him to recoup the 1913 value of his stock tax-free;²¹⁹ and, in theory at least, although rarely in fact, distributions out of pre-1913 earnings or pre-1913 increase in value, cannot exceed the 1913 value of the stock.²²⁰ But certainly these considerations do not apply to a stockholder who acquired his stock after 1913. Moreover, even the pre-1913 shareholder should not be heard to com-

215. Except as to companies, such as personal holding companies which are subject to surtax on account of non-distribution, and which may have taxable income and earnings of the taxable year, but a deficit for past years. Even here, however, the clause does not afford full escape, for such a company may have taxable net income but no earnings for the taxable year. The writer has elsewhere advocated the taxation of stockholders of personal holding companies as partners. RUBICK, *loc. cit. supra* note 109, at 220. However, if such companies are to continue to be taxed as at present, it would be better to supplant the last half of § 115 (a) by a provision similar to that of § 351 (d) of the 1936 Act, whereby the personal holding company surtax could be avoided if the stockholders included their pro-rata shares of the company income in their individual returns.

216. See p. 867 *supra*.

217. E. g., *Ways and Means Committee Report*, H. R. REP. No. 704, 73d Cong., 2d Sess. (1936) 15. See also SEIDMAN, *op. cit. supra* note 25 at 536-537.

218. E. g., *Senate Finance Committee Report*, SEN. REP. No. 558, 73d Cong., 2d Sess. (1936) 36.

219. If he were to sell his stock, his basis would be 1913 value, if that was above cost.

220. HOLMES, *FEDERAL TAXES* (6th ed. 1925) 810.

plain if he is taxed on pre-1913 earnings distributed after that date, when a stockholder who purchased stock in 1940 for \$10,000 and received shortly thereafter, a \$5,000 dividend which depletes the value of his stock by \$5,000, is taxed on that amount.²²¹

The elimination of the exemption of pre-1913 earnings would permit a substantial simplification of the provisions of Section 115. Subsections (b) and (d) could be cut in half and most of the complex provisions of subsections (l) and (m) could be excluded.

The continued exemption of *unrealized* increase in value is justified because until actual realization, such increase is speculative and conjectural. Furthermore, since it is now the clear policy of the law to exclude distributions from realized but *unrecognized* increases in value, there is no sound reason for including distributions out of unrealized appreciation. However, if the distinction between post-1913 and pre-1913 earnings is to be obliterated, the corresponding distinction between post-1913 increases in value and pre-1913 increase in value should also be destroyed, so that distributions out of the latter source, if in excess of basis, will become taxable. In fact, even if the line between earnings before and after March 1, 1913 is maintained, any excess of distributions out of pre-1913 appreciation should be made taxable.

3. In the light of the amendments to Section 115 made by the Second Revenue Act of 1940, it seems possible to formulate a workable concept of "earnings or profits." To begin with, it comprises *actual income* and expenses, as distinguished from *taxable income* or *deductible* expenses. Next, it contemplates only *realized*²²² gains and losses as distinguished from mere enhancement or decline in the value of assets; subject to the limitation that there is added or detracted only that portion of the realized gains or losses which is *recognized* (as distinguished from taxed or allowed) in determining taxable net income. To this extent and to the extent that the earnings of a corporation may include the earnings of a predecessor corporation, taxable net income and earnings or profits are integrated. This may mean that a particular gain or loss is computed and that a particular distribution is characterized, not in accordance with good accounting practice, but in conformity with wholly artificial precepts of tax law designed to protect the revenue. However, save for these exceptions, the statutory scheme contemplates that the determination of earnings or profits shall conform to the best accounting practice.²²³

221. U. S. Treas. Reg. 103, § 19.22 (a)-1; *Lynch v. Hornby*, 247 U. S. 339 (1917).

222. As indicated p. 903 *supra*, it seems reasonably clear that a distribution does not effect realization.

223. *Ways and Means Committee Report*, H. R. REP. No. 2894, 76th Cong., 3d Sess. (1939) 43.