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# INCONSISTENCIES AND IRREGULARITIES ARISING OUT OF THE INTERNAL REVENUE CODE'S "EARNINGS AND PROFITS" AND "DIVIDEND" PROVISIONS

by

John Andrew Jones\*

THE statutory enactments of the Internal Revenue Code dealing with the concept of "earnings and profits" have, in the past, stimulated much interest in statutory reform. Some of the provisions are, on their face, patently inconsistent with others. However, because of the lack of litigation in this area, many of the most blatant inconsistencies have lain dormant throughout the years and have been re-enacted in each revision of the Code. One recent case, *Baker v. United States*,<sup>1</sup> has brought into focus some of the more obvious inconsistencies between the provisions which control the time and amount of reduction of the earnings and profits account upon a corporate distribution.<sup>2</sup> Because the number of inconsistencies in this area of the Code is so great, the scope of this Article will be limited primarily to a consideration of the problems accented by *Baker*.

## I. OPERATION OF THE STATUTES UNDER CONSIDERATION

*Importance of the Concept of Earnings and Profits.* A brief discussion of the general concept of earnings is in order because "earnings and profits" is the gauge against which shareholders must measure a corporation's distributions to determine which portion of such distributions is taxable to them as "dividend."

Actually, the taxability of corporate distributions rests upon the statutory concepts of "dividend" and "earnings and profits." While the statute sets out the meaning of "dividend" fairly well, it shifts the main burden of definition to "earnings and profits," which is undefined in the Code and has no counterpart within the framework of generally accepted accounting principles, or in the field of corporate law. It is not the same as accounting surplus,<sup>3</sup> legal surplus, or accumulated taxable income. Rather, it has been described as a "nebulous no-man's land somewhere between accounting surplus and taxable income."<sup>4</sup> As interpreted by the Commissioner and the courts, "earnings and profits" has come to have a functional rather than a formal definition—in general, it is an approximation of a corporation's power to make distributions which represent more than a return of original capital investment—and the only way

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<sup>1</sup> 460 F.2d 827 (8th Cir. 1972).

<sup>2</sup> Compare INT. REV. CODE of 1954, §§ 312(a), (e), with § 316.

<sup>3</sup> Accountants have sometimes assumed that a corporation's earned surplus account is an adequate measure of its accumulated earnings and profits. However, even though this is sometimes true, it is a dangerous assumption to make since both tax accounting and generally accepted accounting principles are becoming more and more sophisticated. As this happens, they tend to draw further apart.

<sup>4</sup> Speidel, *Earnings and Profits Rules Can Increase Tax Free Distributions to Shareholders*, 3 TAXATION FOR ACCOUNTANTS 242 (1968). This article contains a good discussion of the basic concepts of earnings and profits.

to arrive at its particular meaning is by analysis of the circumstances of each case in the light of this special purpose.<sup>5</sup>

The presence of earnings and profits has no direct tax impact on the corporation itself, although there are many areas where earnings and profits affect the corporation indirectly.<sup>6</sup> It is the shareholders, the recipients of corporate distributions, that are primarily concerned with the balance in the earnings and profits account.

To see why a corporation's earnings and profits account is an important concern to its shareholders, one need only look to the definition of dividend contained in section 316(a) of the Internal Revenue Code: a dividend is a corporate distribution to stockholders out of earnings and profits of the taxable year or out of those accumulated since February 28, 1913. Therefore, it is the existence or non-existence of current or accumulated earnings and profits that determines whether an ordinary corporate distribution is to be treated as ordinary income (a dividend) or as a return of capital. If the corporation lacks current or accumulated earnings and profits at the time of distribution, the distribution is treated as a return of capital to the extent of the stockholder's investment; any excess is taxed as capital gain.

Keeping in mind the importance of the concept of earnings and profits, the statutory framework dealing with the effect of certain transactions (specifically, redemptions and partial liquidations) on the earnings and profits account, and the resultant tax effect of subsequent distributions to shareholders, is examined in detail.

*Background and Interrelationship of Internal Revenue Code Sections 312(a) and (e) and 316(a)(2).* The sections under consideration establish a simple pattern.<sup>7</sup> Section 316 provides the definition of a "dividend" for use throughout the Code. Its principle application is in conjunction with provisions governing the tax treatment of stockholders receiving corporate distributions which are not qualified for the more favorable "sale or exchange" treatment under other sections.<sup>8</sup> On the other hand, section 312 provides the rules which govern the effect of a distribution on the earnings and profits account of the corporation. Section 312 operates independently of section 316(a); its rules govern the effect which any distribution has upon the earnings and profits account regardless of whether or not the distribution is taxed as a dividend.

Section 312(a) requires that a reduction be made in the corporation's earnings and profits account upon any distribution, including one in redemption,

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<sup>5</sup> For a good discussion of how earnings and profits are to be calculated, in light of various hints in the Code and Regulations, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 7.04 (3d ed. 1971).

<sup>6</sup> Some examples where earnings and profits do have an indirect effect are the accumulated earnings tax, the credit for foreign taxes deemed paid, and the computation of subpart F income taxable to a U.S. shareholder of a controlled foreign corporation.

<sup>7</sup> For a more detailed analysis of the interrelationship of these sections, see Edelman, *Eighth Circuit's Baker Decision: Filling a Statutory Gap by Judicial Pragmatism*, 38 J. TAX. 66 (1973).

<sup>8</sup> INT. REV. CODE of 1954, § 301(c)(1). For "sale or exchange" provisions, see *id.* §§ 302, 331, 346.

made by the corporation to its shareholders.<sup>9</sup> Such reduction must be in the full amount of the distribution, except insofar as section 312(e) requires that no such reduction shall be made for the part of any distribution in redemption or partial liquidation which is "properly chargeable to [the] capital account."<sup>10</sup> Interestingly, neither section 312(e) nor the regulations thereunder describe a method of determining which part of the liquidation or redemption distribution is properly chargeable to the capital account, and, thus, not chargeable to earnings and profits. Consequently, through the years the Government has never missed an opportunity to argue in favor of a maximum charge to the capital account. During one period it argued that the amount of a terminal distribution was to be charged first to the entire capital account.<sup>11</sup>

The Government later gave up that argument and, until the promulgation of Revenue Ruling 70-531,<sup>12</sup> both the courts and the Internal Revenue Service applied the statutory mandate by requiring that the redemption price first be applied against the redeemed shares' pro rata portion of the capital account, and then applying the entire balance of the redemption price to reduce "earnings and profits."<sup>13</sup> In Revenue Ruling 70-531, the Internal Revenue Service has attempted to change this rule radically, and retroactively revoke its past application. The ruling states the new Service position that, on a redemption of stock, earnings and profits are first to be reduced by the redeemed shares' pro rata portion (regardless of the amount of the redemption price), and the balance of the redemption price not thus allocable to earnings and profits is to be charged to the capital account.

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<sup>9</sup> INT. REV. CODE of 1954, § 312(a) provides, in part: "General Rule—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased . . . ."

<sup>10</sup> *Id.* § 312(e).

<sup>11</sup> This Government argument was based on the United States Supreme Court decision of *Foster v. United States*, 303 U.S. 118 (1938). In *Foster* the corporation had pre-1913 earnings and profits. The Supreme Court held that no part of a redemption distribution was properly chargeable to post-1913 earnings and profits, and that pre-1913 earnings and profits could be wiped out in their entirety. For a good discussion of the Government's theory, see Edelstein & Korbel, *The Impact of Redemption and Liquidation Distributions on Earnings and Profits: Tax Accounting Aberrations Under Section 312(e)*, 20 TAX L. REV. 479, 496 (1965).

<sup>12</sup> 1970-2 CUM. BULL. 76.

<sup>13</sup> See William D.P. Jarvis, 43 B.T.A. 439 (1941), which provided the impetus for this statutory interpretation. There, a corporation which, in 1915, had issued 10,000 shares of its single class of \$100 par stock at a premium of \$910,000 (*i.e.*, for a total of \$1,910,000), subsequently redeemed 10% of these shares for \$1,160,000. The redemption distribution was held to be chargeable to capital account only to the extent of the par value of the redeemed shares (\$100,000) and of 10% of the paid-in surplus (\$91,000), while the remaining \$969,000 was treated as chargeable to post-1913 earnings and profits.

The Board limited *Foster* to preventing the avoidance of tax by permitting redemption distributions not taxable as dividends to offset post-1913 earnings and profits, while leaving pre-1913 earnings and profits available for subsequent tax free distribution. Since there were no pre-1913 earnings and profits on hand, there was no comparable "opportunity of escape." Consequently, upon a 10% liquidation only the paid-in capital was to be reduced by 10%. The remainder of the distribution reduced post-1913 earnings and profits; a like amount of earnings was presumably taxed to the recipients (albeit not as dividends) and there was no reason to believe that Congress intended to treat later distributions as being derived from the same source, so as to tax this amount the second time.

The Treasury finally conceded in G.C.M. 23460, 1942-2 CUM. BULL. 190, that its position was untenable, and acquiesced in the *Jarvis* case, 1942-2 CUM. BULL. 10. The acquiescence was withdrawn in Rev. Rul. 70-531, 1970-2 CUM. BULL. 76.

This ruling has been severely criticized in a recent article,<sup>14</sup> in that it conflicts with the clear requirements imposed by the language of section 312(e),<sup>15</sup> it conflicts with the fundamental axiom that unrealized and unrecognized gains and losses are not to be taken into account in determining earnings and profits,<sup>16</sup> and it conflicts with the legislative history of the adoption of section 312(e) as a part of the Internal Revenue Code of 1954.<sup>17</sup>

At least one court<sup>18</sup> has cited this article in support of its refusal to apply the rule of Revenue Ruling 70-531.<sup>19</sup> In light of this decision, it seems that the Revenue Service has once again failed in an attempt to increase the portion of a liquidation or redemption distribution chargeable to the capital account, and the traditional rule of charging to the capital account an amount equal to the redeemed shares' pro rata portion of the capital account continues to be applicable.

Another problem that neither sections 312(a) or (e) specifically address is the one of priority of charge to earnings and profits as between ordinary distributions which are afforded dividend treatment, and those made in redemption or partial liquidation. On its face, section 312(a) makes no distinction between the two types of distributions other than that required by the limiting language of section 312(e). Therefore, the only rational conclusion to be drawn from the wording of the two sections is that any portion of a distribution in redemption or partial liquidation, if not properly chargeable to the capital account, should be encompassed within the provisions of section 312(a) along with all other types of distributions which reduce earnings and profits.

Thus, sections 312(a) and (e) deal only with the effect of distributions on earnings and profits at the corporate level. A timing rule which requires reduction "on the distribution" is contained in section 312(a), but section 312 does not contain any rules as to the priority, if any, to be accorded different types of distributions.

Section 316 defines the term "dividend."<sup>20</sup> The phrase "any distribution" appears in section 316 three times—in the introductory and concluding phrases of section 316(a), and in the parenthetical phrase in section 316(a)(2)—and problems have arisen as a result of inconsistent definitions given these identical phrases.

On first reading, it would appear that the term "any distributions" in the parenthetical phrase in section 316(a)(2) refers to any distribution which

<sup>14</sup> Edelstein, *Revenue Ruling 70-531: Section 312(e) Revisited*, 26 TAX L. REV. 855 (1971).

<sup>15</sup> *Id.* at 856.

<sup>16</sup> *Id.* at 857, 858.

<sup>17</sup> *Id.* at 859.

<sup>18</sup> Herbert Enoch, 57 T.C. 781 (1972).

<sup>19</sup> *Id.* at 802 n.15. In rejecting the ruling, the court applied the traditional rule established in *Jarvis*.

<sup>20</sup> INT. REV. CODE OF 1954, § 316(a) provides in part:

For purposes of this subtitle, the term 'dividend' means any distribution of property made by a corporation to its shareholders . . . (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits.

would, absent the phrase, reduce earnings and profits in accordance with the provisions of section 312(a). However, a line of cases<sup>21</sup> dating back to 1928 has consistently held that redemption distributions which qualify for "sale or exchange" treatment are not encompassed within the meaning of "any distributions" as it appears in the introductory and concluding phrases of section 316(a). This conclusion was based on the simple fact that such distributions are not considered dividends for purposes of section 316.

It is logical to conclude that the same restrictive meaning should be accorded to the identical language in section 316(a)(2). However, in the face of this very argument made by a taxpayer, the United States Court of Appeals for the Eighth Circuit, in *Baker v. United States*,<sup>22</sup> decided that such argument could not stand and that the literal meaning of the term as used in the parenthetical phrase must control in spite of prior inconsistent interpretations of the phrase in other parts of the section. As a result of the conclusion reached by the court in *Baker*, the term "distributions" is accorded different meanings within the same sections; "distributions" as used in the introductory and concluding phrases of section 316(a) excludes redemption distributions, but "distributions" as used in the parenthetical phrase of section 316(a)(2) includes redemption distributions. The task of the court in *Baker* was to resolve the inconsistencies.

## II. SHOULD REGULAR DISTRIBUTIONS BE GIVEN PRIORITY IN THE REDUCTION OF CURRENT EARNINGS AND PROFITS?

*Facts of Baker.* The sole issue on appeal of the case concerned the tax treatment of ordinary distributions to corporate shareholders when a corporation with no accumulated earnings and profits had current earnings and profits which were insufficient to cover both ordinary distributions and selective redemption distributions paid out during the fiscal year. Whether either distribution was to be given priority as a charge to current earnings and profits was a question of first impression.

The district court held that ordinary dividends are to receive preferential treatment in reducing earnings and profits. The court of appeals was in full agreement that the district court was correct in rejecting a taxpayer argument which would result in a priority for redemption distributions in reduction of current earnings and profits. Judges Gibson and Bright, for different reasons, found that the Internal Revenue Code required priority treatment be given ordinary distributions.<sup>23</sup> Judge Lay found that neither distribution should be given preference and that a pro rata reduction of the current earnings and profits account is required.<sup>24</sup> The trial court was thus affirmed by a divided vote.

The taxpayers were shareholders in a corporation which, at the beginning of its fiscal year, had no accumulated earnings and profits. For the year in

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<sup>21</sup> *Hellmich v. Hellman*, 276 U.S. 233 (1928). See also *Associated Tel. & Tel. Co. v. United States*, 306 F.2d 824 (2d Cir. 1962); *Atlantic City Elec. Co. v. United States*, 161 F. Supp. 811 (Ct. Cl. 1958); *Michael C. Callan*, 54 T.C. 1514 (1970).

<sup>22</sup> 460 F.2d 827 (8th Cir. 1972).

<sup>23</sup> *Id.* at 836-53.

<sup>24</sup> *Id.* at 835.

question, it had current earnings of \$1,553,636.34. During the fiscal year, the corporation redeemed part of its issued and outstanding no-par common stock from certain shareholders (not including the taxpayers) at a cost of \$1,651,561.70, and also distributed \$1,880,179.75 cash to its shareholders as distributions with respect to stock. The latter sum included the distribution of \$4,925 to plaintiffs. It was stipulated that, of the \$1,651,561.70 paid out as redemptive distributions, \$157,002.57 was properly chargeable to the corporation's capital account.<sup>25</sup> The remainder, \$1,494,559.13, was charged by the corporation to its earnings and profits account.

Naturally, the taxpayers urged that the balance of the earnings and profits account, in other words, \$59,077.21, was all that remained available for the ordinary distributions, since the redemption distributions had otherwise absorbed the earnings. Thus, they urged that the portion of their distribution which was taxable as ordinary income was limited to their share of that remainder. The Government argued that the ordinary distributions (\$1,880,179.75) must be given priority and charged first against the earnings and profits account (\$1,533,636.34), leaving only the difference, if any, available for the redemption distributions. The district court upheld the Government's position and denied plaintiffs' relief.<sup>26</sup>

*Per Curiam Opinion.* On appeal, the taxpayers argued that the words "any distributions," as used in the parenthetical clause of section 316(a)(2), are limited to ordinary distributions and do not encompass redemptive distributions, which allegedly reduce earnings and profits under section 312(a) on the date of distribution.<sup>27</sup> The court felt that it would be a strained rule of statutory construction to construe words of general meaning as specifying a particular meaning. They stated that the effect of such a construction would be to include language within the statute which Congress failed to insert in it. It was felt that to make such a construction would be to amend the Act and usurp the function of the legislature, because courts are not at liberty to modify plain

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<sup>25</sup> In the per curiam opinion of *Baker v. United States*, 460 F.2d 827, 829 (8th Cir. 1972), it was noted that the allocation to the capital account apparently was not made in accordance with Rev. Rul. 70-531, 1970-2 CUM. BULL. 76, and that nothing in the opinion was meant to be an opinion on the merits of the ruling. See text accompanying note 12 *supra*.

Judge Gibson voices his displeasure with the inadequacy of the stipulation:

The difficulties of this case are compounded by the inadequacies of the stipulation upon which the case was tried. According to the stipulation the corporation made total distributions—redemptive and ordinary—of more than \$3,530,000. It had earnings and profits of only \$1,533,000, and the distributions were 'properly chargeable to capital' in only the amount of \$157,000. Thus we are left to speculate as to the source of more than \$1,820,000 used to make these distributions . . . Thus both the taxpayer and the Government have put this Court in the position of deciding a question of considerable importance to the federal income tax program as a theoretical, abstract question. 460 F.2d at 835.

<sup>26</sup> *Baker v. United States*, 308 F. Supp. 1129 (D. Neb. 1970).

<sup>27</sup> This argument was based on the holding of the Supreme Court in *Hellmich v. Hellman*, 276 U.S. 223 (1928). There, the Court simply held that the definition of a dividend under the forerunner of § 316(a) did not include redemptive and liquidating distributions, because another special section governed their treatment. The court in *Baker*, however, held that it does not follow that this separate treatment gives a special meaning to the generic words "any distribution" used elsewhere in § 316(a)(2). See discussion *supra*, at text accompanying note 21.

words by judicial construction. The court also determined that if the words "any distribution" were read to mean any *ordinary* distribution, throughout the entire section, the third sentence of section 316(a) would in effect negate the purpose of section 312(a). Therefore, the court concluded that Congress intended all types of distributions to be included within the computation set forth in section 316(a)(2) and that the term "any distributions" in the parenthetical phrase in section 316(a)(2) literally refers to any distribution which would, absent the phrase, reduce earnings and profits in accordance with the provisions of section 312(a).

There is little doubt that this conclusion is both necessary and correct. If Congress had considered such a situation, undoubtedly it would have interpreted the phrase in this manner, in order to prevent withdrawal of earnings at capital gains rates. However, the impact of the conclusion is that the term "distributions" has differently interpreted meanings, depending upon where the term appears in section 316.<sup>28</sup> It excludes redemptive distributions, except where they are used in the context of the parenthetical phrase of section 316(a)(2).

All three judges agreed that the taxpayer's basic argument that redemptive distributions should be given priority over ordinary distributions in the reduction of current earnings and profits was wrong. But only two of the judges ultimately concluded that priority must be accorded ordinary distributions in reduction of current earnings, and their decisions were based on different reasons.

*Opinion of Judge Gibson.* Judge Gibson found support for his general approach to the problem in the Supreme Court case of *Foster v. United States*.<sup>29</sup> First, he reasoned, according to *Foster*, the use of bookkeeping terms and accounting forms and devices cannot be permitted to devitalize valid tax laws. Adopting the taxpayer's contention that redemptive distributions should be given priority treatment would result in the use of such terms, forms, and devices to devitalize a tax Congress clearly intended to impose.

Further, section 312(a) applies only to ordinary distributions and only section 312(e) applies to distributions made in redemption. Congress appears to have been consistent throughout the Revenue Act in referring to ordinary distributions as "distributions with respect to stock."<sup>30</sup> Therefore, the phrase "distributions... with respect to its stock" contained in the first sentence of section 312(a) refers only to ordinary distributions, as distinguished from terminal distributions (distributions in liquidation, partial liquidation, or redemption). Judge Gibson argued that section 312(e), in contrast to the dividend definition contained in section 316, does not determine the tax treatment to be given to a redemption distribution, but merely determines the tax accounting consequences of a redemption distribution at the corporate level.

According to Judge Gibson, the legislative history behind the enactment of

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<sup>28</sup> See text accompanying notes 21-22 *supra*. See also Edelman, *supra* note 7, at 66.

<sup>29</sup> 303 U.S. 118 (1938).

<sup>30</sup> See 460 F.2d at 838. Judge Gibson concluded that since the Treasury found it necessary in Treas. Reg. § 1.311-1(a) (1955) to specify that distributions made in respect to stock included distributions made in redemption of stock, it suggests that that is not its ordinary meaning.



section 316(a)(2)<sup>31</sup> shows that "... Congressional intent was not merely to give relief to deficit corporations, but to tax distributions of current earnings as dividends in the hands of shareholders. Effect should be given to this intent unless a contrary result is clearly manifested by another section of the statute."<sup>32</sup> Since no contrary result is clearly manifested by another section of the statute, congressional intent should be upheld by giving ordinary distributions priority in the reduction of current earnings and profits.

In summary, he concluded that section 312(a) had no application to the problem and that the answer to the question must be provided by reference to sections 312(e) and 316(a)(2). He felt that those two sections, read together, excluded all redemptive distributions from the determination of current earnings and profits. Therefore, it was his belief that no portion of a redemption distribution was to be charged against current or accumulated earnings and profits account at the time of the distribution, as are ordinary distributions; not only were they given priority in reduction of earnings and profits over redemption distributions, but under his approach, no portion of a redemption distribution is ever to be chargeable to the current earnings and profits account. It is impossible to determine how he would treat a reduction of accumulated earnings and profits, if any existed upon such a distribution.

Clearly, Judge Gibson was "grasping at straws" to find a way to support his predetermined conclusion that ordinary distributions must be given priority over redemption distributions in reduction of the current earnings and profits account to prevent withdrawal of earnings and profits at capital gains rates. One cannot argue with his conclusion, but a great portion of his supportive reasoning is illogical. By far, the greatest fault in his analysis is his conclusion that section 312(a) has no application to the problem. Several times in his opinion, he took the writings of authorities and legislative history out of context and clearly misinterpreted their meaning to support his conclusion that section 312(a) is inapplicable.<sup>33</sup> His interpretation—that section 312(e) alone applies to redemption distributions—would leave additional gaps in the

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<sup>31</sup> Section 316(a)(2) was enacted in 1936 specifically to provide relief for those corporations which had no accumulated earnings and profits, or a deficit, so that they could not, under the then-existing case law, pay a "taxable" dividend for purposes of obtaining the dividends-paid credit under the simultaneously enacted undistributed profits tax. See Revenue Act of 1936, ch. 690, § 115(a)(2), 49 Stat. 1687 (1936). See also H. Rep. No. 2475, 74th Cong., 2d Sess. 8 (1936).

<sup>32</sup> 460 F.2d at 841.

<sup>33</sup> See for instance his reference, *id.* at 838, to the words of the Senate Committee found in 3 U.S. CODE CONG. & AD. NEWS, 83d Cong., 2d Sess. 4678 (1954), relating to its rejection of an additional rule which the House bill supplied for purposes of making definite the manner in which earnings and profits should be allocated upon occurrence of a partial liquidation or redemption.

Judge Gibson somehow interpreted this rejection to imply that the Senate did not assume that § 312(a) had application in determining the accounting results of a redemptive distribution. That was clearly not the case. The Senate was merely saying that they were satisfied with the way the Service was then interpreting the "properly chargeable to capital account" portion of subsection 312(e). This particular comment had no relevance to the question of the applicability of § 312(a) to a redemptive distribution. See also 460 F.2d at 839, the reference to the excerpt taken from Edelman & Korbel, *supra* note 11, at 480, 481. Judge Gibson interprets their words to mean that § 312(a) does not apply to liquidating distributions when in actuality they were merely stating the truism that § 312(e) governs the determination of the proper charge to earnings and profits, under § 312(a), upon a distribution in redemption or partial liquidation.

makeup of section 312. For example, there would be no rule by which to measure the amount of a redemption distribution. Judge Gibson's reliance upon the legislative history behind the enactment of section 316(a)(2) in support of his conclusion that congressional intent was not only to give relief to deficit corporations, but also to tax distributions out of current earnings as dividends to the shareholders, is also subject to attack. It is dangerous to use the congressional intent behind the adoption of section 316(a)(2) as support for his interpretation of this statutory scheme, which deals with the reduction of earnings and profits upon redemption distribution, since, at the time of enactment, section 316(a)(2) had reference to an entirely different statutory provision, the undistributed earnings tax, which has long since been abandoned.

Although the ultimate conclusion reached by Judge Gibson is undoubtedly the one Congress would have desired, had they considered the problem, that they did not is made obvious by the contorted analysis necessary to reach that result.

*Opinion of Judge Bright.* Judge Bright disagreed with Judge Gibson to the extent that Judge Gibson believed that redemptive distributions may not be charged against current earnings and profits for tax accounting purposes under section 312(a). He argued that redemptive distributions which are not taxable under section 301 are not taken into consideration in determining a corporation's current earnings and profits available for dividends under section 316(a). Section 316(a) sets out a hypothetical year-end accounting method for determining the taxability of an ordinary distribution, whereas section 312(a) merely provides a day-to-day accounting procedure for calculating the current status of the earnings and profits account.

Also, a distribution of property by a corporation, whether ordinary or redemptive, serves to decrease the corporation's earnings and profits account under the accounting procedure set forth in section 312(a), but this decrease has no effect upon the taxability of an ordinary distribution made during the same tax year by a corporation which had no accumulated earnings and profits.

In the case of a corporation with no accumulated earnings, Judge Bright urged, ordinary or redemptive distributions may be charged against current earnings and profits "on the distribution" under section 312(a), but distributions which do not fall within section 301 are not taken into consideration in determining the year-end earnings and profits fund available for dividends under section 316(a).

This reasoning is based on the wording of section 316(a). The last sentence in that section means that section 316(a) does not encompass distributions which do not fall within section 301.<sup>34</sup> Construing section 316(a) in that way, there is no conflict between its provisions and the provisions of section 312(a), because the sections merely set out separate accounting concepts which are relevant to the separate purposes served by each section. In summary, Judge

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<sup>34</sup>The last sentence provides that, "[t]o the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection." INT. REV. CODE of 1954, § 316(a) (emphasis added).

Bright agreed with Judge Gibson's result that ordinary distributions are to be given priority in the reduction of current earnings and profits. However, he did not agree with Judge Gibson's theory that section 312(a) did not apply to redemption distributions. He felt that redemption distributions were chargeable against current earnings and profits through section 312(a), but only after ordinary distributions were so charged in full. He rested his opinion on the conclusion that the last sentence of section 316(a) excludes redemption distributions from the operation of section 316(a); therefore, redemption distributions are not to be taken into account in determining the current year's earnings and profit fund available for dividends.

The conclusion reached by Judge Bright, along with Judge Gibson, was in contrast to that of Judge Lay. They reached the conclusion which Congress probably would have intended had it considered the problem. Judge Bright's reasoning has been attacked on the ground that his reading of the last sentence of section 316(a) is unsatisfactory.<sup>35</sup> Congress intended to make certain that a redemption distribution which does not qualify for sale or exchange treatment will be treated as a dividend, but the obverse, upon which Judge Bright rests his opinion, does not automatically follow. However, based upon the prior decisions<sup>36</sup> that interpret the phrase "any distributions" as used in the first sentence of section 316(a) to mean only "ordinary distributions," the result is at least arguably correct.

It is interesting to note that Judge Bright does not cite any of this prior case law in support of his conclusion that redemption distributions are excluded from the application of section 316. Undoubtedly, this was because the court, in its per curiam opinion, had previously interpreted the same term contained in the parenthetical phrase of section 316(a)(2) as meaning literally "any distribution" (ordinary, liquidation, redemption, etc.), and Judge Bright felt it better to find other authority for the desired result.

Another flaw in Judge Bright's opinion is that it does not specify how sections 316(a) and 312(a) should interact.<sup>37</sup>

*Opinion of Judge Lay.* Judge Lay felt that both Gibson and Bright overlooked the fact that subchapter C of the Internal Revenue Code presents a comprehensive statutory scheme for the taxation of corporate distributions, and that sections 312(a), (e) and 316(a)(2) were intended to play some operative part in the treatment to be given the dividend and redemptive distributions made in the year in question.

He reasoned that giving effect to all of the words of each statute, and thus achieving harmony between the sections, one must conclude that dividends can claim no priority in the reduction of current earnings, and that each distribution, whether redemptive or dividend in nature, must play some part in reducing current earnings in a year, when those earnings are insufficient to cover all distributions.

Further, section 312(a) applies to redemptions as well as ordinary distribu-

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<sup>35</sup> See Edelman, *supra* note 7, at 69.

<sup>36</sup> Cases cited note 21 *supra*.

<sup>37</sup> For a thorough discussion of this flaw, see Edelman, *supra* note 7, at 69.

tions because the phrase "with respect to its stock," as used in that section, encompasses distributions made in redemption.<sup>38</sup> The words "on the distribution" indicate a point in time when a distribution chargeable to earnings actually reduces that account, and this leaves no room for preferential treatment of any distribution.

Judge Lay argued that section 312(a) does not contain special rules which require one method for reducing current earnings and another for reducing accumulated earnings; both earnings sources receive similar treatment. The parties agreed that corporate distributions, whether dividend or redemptive, reduce accumulated earnings at the time of their distribution and in order of their distribution, without priority. In the absence of language to the contrary, the same result occurs in the reduction of accumulated earnings. Hence, no priorities can be claimed.

Section 312(e) plays the limited role of removing from the earnings adjustment under section 312(a) that portion of a redemption distribution which is properly chargeable to capital, according to Judge Lay. This, of course, requires that allocation of the distribution be made before any charge is made to earnings. It seems clear, he argued, that once the allocation is made under section 312(e), that provision has no further operation and the rules of section 312(a) thereafter govern the allocated earnings portion of a redemption distribution.

Judge Lay contended that the parenthetical clause of section 316(a)(2) is not intended to mean that these earnings are so computed for the purpose of making them first available for dividends. If that were the correct interpretation, the operations of section 312(a) and section 312(e) would be completely negated.<sup>39</sup> Congress could not have intended that section 316(a)(2) be interpreted in a manner which would create such a manifest disharmony between these statutes.

To Judge Lay, the operative effect of section 316 is to define those distributions which shall be considered "dividends." Dividends are there defined as "any distribution" which comes "out of" either current or accumulated earnings. Nothing in section 316 governs the actual reduction of earnings. In fact, section 316 does not become operative until the earnings account has been reduced; therefore, the rules of section 312(a) must be applied first, before the section 316 definition of a dividend can function. The operations of section 312(a) and section 316(a)(2) are interlocking steps in the statutory scheme of taxing corporate distributions.

Further, every distribution, whether redemptive or dividend, reduces avail-

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<sup>38</sup> This conclusion was based on the fact that Treas. Reg. § 1.311-1(a) (1973) states that redemptive distributions are included within the meaning of that same phrase as used in § 311, and that the statutes must be construed *in pari materia* in absence of a statutory definition. Therefore, the definition contained in the regulations under § 311 must be deemed to interpret the phrase as it is used throughout the entire statutory scheme.

<sup>39</sup> 460 F.2d at 849. Judge Lay stated:

[I]f redemptions which are made earlier in time than dividend distributions are forced to wait in abeyance until the subsequent dividends have been given the first opportunity to absorb earnings, then the redemptions cannot affect the taxability of subsequent distributions as § 312(e) indicates, nor can they decrease earnings at the time of their distribution as § 312(a) indicates.

able earnings at the time of distribution; this occurs because of section 312(a). The parenthetical clause of section 316(a)(2) merely sets forth the manner of computing current earnings when those earnings are a source of dividend distributions. The Treasury Regulations allocate the current earnings on a proportionate basis among the various distribution dates of the year, rather than ratable to each and every day of the year.<sup>40</sup>

Judge Lay argued that the computation made under section 316(a)(2) cannot control which distributions reduce earnings on their distribution dates. Section 312(a) applies to both redemptive and dividend distributions, and requires a reduction of earnings on the date of such distribution. Thus, if a distribution reduces current earnings on the date when made, the only purpose of the year-end computation is to facilitate a determination of the extent of the earnings existing on the distribution date. In a year when both types of distributions are made from current earnings, and these earnings are insufficient to cover all distributions of the year, the only reasonable conclusion is that the total current earnings computed at the end of the year, without regard to the diminishing effect of any distribution made during the year, are to be prorated among all distributions, both dividend and redemption.

In summary, Judge Lay felt that the parenthetical clause of section 316(a)(2) merely provides a method of computing the total extent of available current earnings, without preempting those earnings for dividends only. Thus, each distribution, dividend and redemption alike, has the effect of decreasing earnings at the time of distribution to the extent of that source as section 312(a) requires. The requirements of section 312(e), and the regulations thereunder, are thereby given effect, since the portion of the redemption which is allocable to earnings will diminish the earnings available for later distributions and thereby have an effect in determining the taxability of subsequent distributions. And, the method of computing current earnings without regard to any distribution made therefrom during the year set forth in section 316(a)(2) will be given literal application. Only in this way can harmony be achieved among these statutes.

If valid, logical analysis of the operation of the statutory scheme is used as the criterion, Judge Lay's opinion is the most commendable; his view of the relationship between sections 312(a) and 312(e) appears to be correct. His opinion is not without its difficulties, however, and has been criticized on the ground that it does not resolve the conflict in timing rules, but merely concludes that neither section provides for any priority among different kinds of distributions.<sup>41</sup> He recognized the conflict between the timing rules of sections 312(a) and 316(a)(2), but did nothing to reconcile it.

He has also been criticized because of his contention that section 312(a) must be applied before the section 316(a) dividend definition can function.<sup>42</sup> He concluded that a distribution can only be defined as a dividend after it has reduced earnings and profits. But in the case of current earnings and profits this contention is incorrect, because the definition of a dividend does not depend

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<sup>40</sup> See Treas. Reg. §§ 1.316-2(b), (c) (1973).

<sup>41</sup> See Edelstein, *supra* note 7, at 70.

<sup>42</sup> *Id.*

upon the state of the earnings account prior to the distribution, but only at the end of the year.

*Observations.* Logic alone would tend to favor the opinion of Judge Lay, while the conclusion reached by Judges Gibson and Bright would seem to be more in keeping with the intent that Congress presumably would have had if they had considered the problem, to give full effect to the policy of not permitting current earnings to escape taxation as dividends merely because redemptive distributions were made in the same year as ordinary distributions. As between the opinions of Judges Gibson and Bright, Judge Bright's is clearly the better reasoned. His views more closely coincide with what appears to be a liberal interpretation of the wording of the statutes involved. However, as pointed out by Edelstein,<sup>43</sup> none of the opinions provide a sound basis for solving the general problem raised by *Baker*. Edelstein feels that as a matter of policy, giving the statutes involved the benefit of the presumption of legislative rationality, sections 312(a) and 316(a)(2) serve related, but nevertheless distinct functions in the overall statutory scheme:

Section 312(a) deals with the effect of distributions on the earnings and profits account, without reference to the definition of 'dividend' contained in Section 316(a) . . . . Section 316(a)(2) supplies a definition of 'dividend' needed principally to enable Section 301(c)(1) to function to tax the shareholders. Accordingly, Section 316(a)(2) contains its own special rules, which can, and must, operate independently of Section 312(a). Accordingly, the priority and time of the effect of distributions on current earnings and profits, solely for the purpose of determining whether a distribution comes within the 'dividend' definition of Section 316(a)(2), must be determined by section 316(a)(2) alone, and not by Section 312(a). If that approach is not taken, there will be an insoluble conflict between the requirements of the two rules. Since we have been told that redemption distributions are not encompassed within Section 316(a), except in the parenthetical phrase of Section 316(a)(2), they should not be taken into account in determining whether a distribution constitutes a distribution of current earnings and profits, and hence falls within the definition of 'dividend' provided by Section 316(a)(2).<sup>44</sup>

This proposed solution is closely akin to that provided in the opinion of Judge Bright. However, Edelstein has improved on it by articulating how sections 316(a) and 312(a) should interact, and by resting the conclusion that redemption distributions are precluded from affecting dividend determination under section 316(a) by application of prior case law<sup>45</sup> rather than through the last sentence in section 316(a).

Given the present statutory framework, Edelstein's proposed solutions to the problems posed in *Baker* appear best. However, it is far from an ideal solution to the problem. Such a solution can be achieved only through statutory reform. One great advance in this area would be the deletion of section 316(a)(2). As a result, total reliance could be placed on the concept of "accumulated" earnings and profits. Not only would this do away with all of the major conflicts in the *Baker* case, but it would also mean a return to the valid tax policy

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<sup>43</sup> Edelstein, *supra* note 7.

<sup>44</sup> *Id.* at 71.

<sup>45</sup> See cases cited note 21 *supra*.

objective of taxing shareholders at ordinary rates only upon receipt of income distributions, not returns of capital.

### III. OTHER INEQUITIES AND INCONSISTENCIES IN THE PRESENT EARNINGS AND PROFITS STATUTORY FRAMEWORK

Through careful planning at the corporate level, it is possible, under the present earnings and profits statutory framework, to reward stockholders with the ultimate in tax benefits—tax-free dividends. Even after *Baker* it is possible to use redemption distributions to an advantage. Accumulated earnings and profits accounts can be reduced by redemption distributions, which, if non-pro rata, are taxed as a return of capital under section 302, and thus decrease the amount which will remain available for use in dividend characterization.

However, most of the inconsistencies arising in the earnings and profits area are a result of the very drastic differences in tax treatment which can be achieved by making ordinary distributions at the proper time. For example, where distributions are made to a stockholder during a year in which the corporation has current earnings and profits, the distributions are applied against the total for the year, regardless of the amount earned at the time the distributions are made. However, in a loss year the rule is different. Where distributions are made to stockholders during a loss year, dividend treatment is determined by whether there were accumulated earnings and profits at the time of the distributions. This rule can work to the advantage of stockholders if the distributions are carefully planned.<sup>46</sup>

Example: Assume that a corporation has accumulated earnings and profits of \$100,000 at the beginning of the year. Its operating earnings for the current year are expected to be \$80,000, but in addition the corporation plans to sell a particular asset at a loss of \$120,000. Thus, there will be a net loss for the year of \$40,000 and accumulated earnings and profits at the end of the year will be \$60,000. If a distribution of \$60,000 were made at the end of the year, it would be fully taxable as a dividend.

Suppose now that the corporation sells the asset and incurs the loss of \$120,000 early in the year before any of the operating earnings have been realized. Since accumulated earnings and profits at the beginning of the year were only \$100,000, there is a deficit in accumulated earnings and profits immediately after the sale. Following through on the planning, the corporation could distribute money or property to its shareholders immediately after incurring the loss. To measure the taxability of the distribution we look at the earnings and profits picture at the time of the distribution. In our example, the earnings and profits are in a deficit position and therefore the distribution is not taxable as a dividend. The stockholders treat it as a return of capital.<sup>47</sup>

If taxation as dividends, based on the balance in the earnings and profits account at the time of distribution, is to be afforded the shareholders in a loss year, why should different rules apply simply because the corporation had a successful year? There is no reason for so distinguishing, and consistency, logic, and tax policy would be better served if the separate rules for taxation of dis-

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<sup>46</sup> For a good discussion of the possibilities, see Speidel, *supra* note 4, at 245.

<sup>47</sup> *Id.*

tributions made from current earnings and profits were done away with. Taxation should depend entirely upon the balance of the "accumulated" earnings and profits account at the time of distribution. This balance should be determined at the end of the tax year of the corporation by a daily pro rata allocation of either the total gain or loss in earnings and profits realized by the corporation in that tax year. Such an arbitrary rule would add stability to the area, provide for more consistent application of the rules, and alleviate the problem of manipulation of the earnings and profits account to suit the needs of the corporation's distribution policy.

The rule embodied in section 316(a)(2), of taxing distributions from current earnings and profits regardless of the state of the accumulated earnings account, has influenced, to a great extent, the time at which corporate distributions should be made. Thus, corporations no longer make the decision of when and how much to distribute solely on the basis of economic considerations. For example:

A corporation has incurred a large deficit in earnings and profits in prior years. Its operations are now profitable, and it has undergone a quasi-reorganization to eliminate the deficit for accounting purposes. The corporation is now in a position to pay out some of its current earnings as dividends. The quasi-reorganization will, of course, have no effect on the earnings and profits deficit. The dividend status of the distributions to stockholders will be measured solely by the corporation's current earnings and profits.

Assume that the corporation is earning income at the rate of about \$100,000 a year and that it plans to distribute 75 per cent of this to its stockholders. If the corporation makes a distribution of \$75,000 each year, the distribution will be fully covered by current earnings and profits and thus fully taxable as a dividend.

Instead of making an annual distribution of \$75,000, it will be better from the stockholder's point of view if the corporation makes a distribution of \$150,000 in every other year. This way, the distribution will be only two-thirds covered by current earnings and profits in the year distributed. One-third could be treated by the stockholders as a return of capital.<sup>48</sup>

Because section 316(a)(2) has outlived its usefulness,<sup>49</sup> tax policy should not play so important a part in determining whether and to what extent distributions should be made. There is no sound reason for requiring that this determination be made because the corporation has a deficit in accumulated earnings and profits, and there is no valid tax policy reason supporting taxation of distributions from purely current earnings and profits. They are, in essence, returns of capital until the deficit in accumulated earnings and profits is made up.

Sometimes, it is possible for a corporation to distribute income to its stockholders in advance of the time the income enters the earnings and profits account. For example, this is accomplished by selecting a financial accounting method which allows treatment of heavy research or start-up costs, or heavy expenditures for the development of oil properties, as deferred charges or capital expenditures, while, at the same time, taking an immediate write-off

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<sup>48</sup> *Id.* at 245-46.

<sup>49</sup> See text accompanying notes 55-56 *supra*.



of these costs as incurred for tax purposes. Since the costs are treated as expenses for tax purposes, they will also reduce earnings and profits and the corporation will generate a deficit in earnings and profits in the early years when the costs are high and the income from operation is low. However, because the costs are deferred for financial accounting purposes, the corporation may begin to accumulate surplus for accounting purposes.

When the development work is nearing completion and it becomes apparent that the corporation will soon be in a position to begin a dividend program, there will be little or no earnings and profits and the corporation might want to make a rather large distribution to its stockholders. In the absence of earnings and profits, the distribution will not be taxable as a dividend and the stockholders will have received a return of their investment tax-free to the extent that the distribution does not exceed their basis in their stock, immediately before the corporation begins to generate earnings and profits.

This advantage afforded the taxpayers because of the discrepancies between the requirements of financial and tax accounting cannot be done away with in the absence of statutory reform. Such reform would necessarily be in the nature of a requirement that, if financial accounting methods which allow the deferral of costs are permissible under state law to determine the amount of earned surplus available for dividend distribution, such methods must also be used to determine the amount of earnings and profits available at the time of distribution for tax purposes. Such a provision would do away with the advantage created by the discrepancy, but many problems would arise as a result of trying to administer the provision. The ability of a young corporation to distribute "dividends" under state law, in the face of a deficit in the earnings and profits account, would necessarily have to be explained by reference to the financial accounting techniques utilized by the corporation.

A closer semblance between the concepts of "earned surplus" and "earnings and profits" would alleviate a great deal of confusion. But, because of the difficulties involved and the ability of those who work with tax problems to live with the concepts as developed, no conceptual changes are likely to occur in this area in the near future.

#### IV. PROPOSED SOLUTIONS TO THE EARNINGS AND PROFIT PROBLEMS

Because of the difficulties that have been encountered by those attempting to provide concrete solutions to problems arising in the area of earnings and profits, and because of the presence of what many think to be antiquated reasoning as the sole support for the dividend taxation of distributions from corporations which have only current earnings and profits, many proposals for reformation of the area have been published. Two of the more notable ones, which are relevant to the problems under consideration, were written by Professor Andrews<sup>50</sup> and Professor Rudick.<sup>51</sup>

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<sup>50</sup> Andrews, "Out of Its Earnings and Profits:" *Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403 (1956).

<sup>51</sup> Rudick, "Dividends" and "Earnings or Profits" *Under Income Tax Law: Corporate Non-Liquidating Distributions*, 89 U. PA. L. REV. 865 (1941).

*The Andrews Approach.* Professor Andrews argues that the concept of "earnings and profits" as the determinant of the type of taxation to be afforded corporate distributions has outlived its purpose. It was the only means available, where the problem was one of timing, to exempt from taxation post-1913 distributions of gains made before that time. However, where the problem is whether there is income at all, against which this present distribution should be charged, the usefulness of this accounting concept is more doubtful.

Andrews feels that even where a corporation has had no earnings, accounting methods are not as reliable an indicator of whether distributions should be viewed as income or return of capital as is the fact that the distribution was made.

Finally, because state corporate laws generally frown upon progressive distributions of capital, there is no reason why the federal government should not indulge a presumption that a corporation behaves within the policy of the laws, and hold a shareholder to his corporation's implicit determination that there are profits to support a dividend.

Andrews recognizes that some situations remain where corporate distributions are, in reality, a liquidation of a shareholder's investment and that he ought to be able to treat the distribution as a return of capital. These situations now qualify for capital gains treatment as section 302 redemptions, section 346 partial liquidations, and those which are exempt because they are made from depletion reserves in the absence of earned surplus and earnings and profits. He recognizes that section 346 distributions are indeed returns of capital because the actual source of the distributions is the assets on the left side of the balance sheet. He does not base his conclusion that distributions from depletion reserves deserve capital treatment on the fact that there are no earnings and profits, but rather on the fact that the distribution is in actuality a return of capital.

Andrews concludes that the distributions which ought to be treated as a return of capital could and should be brought within the concept of a partial liquidation by special statutory provision. Such an approach would be more sound theoretically, and would eliminate many controversies which cannot be satisfactorily resolved because of the lack of a sense of purpose under the present statute.

The American Law Institute considered adoption of a proposal similar to the one espoused by Professor Andrews, but concluded that, in light of the long-continued existence of the requirements of earnings and profits for dividend distributions, not enough would be gained to justify a recommendation for its elimination.<sup>52</sup>

The American Law Institute noted that provisions of the Code other than the dividend provision of section 316 rely on the concept of earnings and profits, and it would be necessary to ascertain whether these sections could be freed from utilization of the concept; its needed retention for such sections

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<sup>52</sup> See Cohen, Surrey, Tarleau & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM. L. REV. 1 (1952). In 1952 the American Law Institute, through its Income Tax Project, engaged in a complete review of the technical provisions of the federal income tax. A committee was formed to accomplish the goal of drafting a revised income tax statute.

might destroy the advantage of its elimination from the main corporate provisions. Further, it would be necessary to retain the concept in the area of distributions from "wasting asset" corporations; otherwise the shareholders would be required to treat the return capital as a taxable dividend.<sup>53</sup> Finally, the American Law Institute felt that the earnings and profits requirement imparts an essential element of fairness into the rules on taxation of dividends.<sup>54</sup>

*The Rudick Approach.* Professor Rudick's proposal was simply to delete section 316(a)(2). He argued that section 115(a) was enacted in 1936 specifically to provide relief for corporations which had no accumulated earnings and profits or a deficit in earnings and profits, so that they could not, under the then existing case law, pay a "taxable" dividend for purposes of obtaining the dividends' paid credit under the simultaneously enacted undistributed profits tax.<sup>55</sup> The parenthetical language, which postpones the determination of current earnings and profits until the end of the year, was included for the purpose of simplifying the determination of the amount of credit in the case of distributions made during the year. Since "[t]he undistributed profits tax which begot the clause is now relegated to limbo"<sup>56</sup> the clause itself is now anachronistic.

As a matter of fairness, he concluded, a shareholder should not be required to treat something that is obviously a return of capital as a dividend. This occurs when a corporation which has an accumulated aggregate deficit in its earnings and profits account makes a distribution in a year in which it has earnings. Such treatment can be circumvented by postponing distributions to subsequent years when there are no earnings, but obviously there is no rational reason to penalize an acceleration of the distributions.

The American Law Institute Income Tax Project Committee<sup>57</sup> also considered a proposal similar to that of Professor Rudick's and rejected it on grounds that the slight statutory complication introduced by the double test of section 316 produces considerable simplification at the administrative level. In other words, if the distributing corporation possesses sufficient current income, the test of earnings and profits for the current year makes it unnecessary to determine the exact status of its accumulated earnings and profits. Further, if a shareholder has recently purchased his stock in a deficit corporation, it is questionable whether he should be treated as merely stepping into the shoes of the seller. In such a case there is no real justification for such escape from taxation. The argument that a shareholder may have invested to obtain the advantage

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<sup>53</sup> It should be noted that, as was pointed out in the above discussion of his proposal, Professor Andrews made provisions for taxation of such distributions at capital gains rates. However, he based his conclusion on the nature of the distribution, not the lack of earnings and profits.

<sup>54</sup> Cohen, Surrey, Tarleau & Warren, *supra* note 52, at 7. It was pointed out that this feeling was felt most acutely with respect to the situation where an original shareholder desires to withdraw some of the funds previously contributed by him to the corporation before the corporation has earned any profits. *But see* Andrews, *supra* note 50, at 1437, where he counters this argument by concluding that the point at which capital is originally contributed is a more desirable cutoff point, after which distributions will be treated as dividends, than is the point provided by the concept of earnings and profits which varies depending upon whether the corporation suffers initial losses or realizes gain.

<sup>55</sup> *See* note 31 *supra*.

<sup>56</sup> *Supra* note 51, at 905.

<sup>57</sup> *Supra* note 52.

of the deficit is, in reality, persuasive in the other direction, since there is no point in creating through tax rules an artificial market in the shares of deficit corporations. The double standard largely coordinates tax consequences with corporate action, because, if a deficit corporation experiencing current profits believes it good corporate policy to declare a dividend, or if a corporation with prior profits but a current loss finds it desirable to maintain a dividend record, there is strong reason for treating the distribution as a taxable dividend.<sup>58</sup>

## V. CONCLUSION

Considering the numerous problems and inconsistencies which arise as a result of the present earnings and profits framework, there can be little doubt that statutory reform should be effected. The difficulties encountered in rationalizing the various conclusions reached in *Baker* highlight the fact that the courts should not be left the task of making sense out of the earnings and profits area of the Code. The *Baker* court found it necessary to fill a statutory gap by judicial pragmatism.

Reform should be in the nature of a deletion of section 316(a)(2), and the addition of rules which provide for the determination of which distributions are to be considered made from "accumulated earnings and profits." This should be done by determining, at the end of the corporation's tax year, the amount to be credited or charged to the accumulated earnings and profits account as a result of gains or losses incurred during the tax year. At the same time, the portion of any distribution which is to be considered a dividend should be determined by checking the balance of the earnings and profits account on the date of distribution as calculated by spreading the entire tax year's gain or loss in earnings and profits on a daily pro rata basis throughout the year. The latter step, which requires dividend determination at the end of the year, will involve no more guesswork for a taxpayer who bases his return on a different tax year from that of the corporation, than does the present year-end calculation under section 316(a)(2). Furthermore, only in exceptional years would any real guesswork be involved.

This argument for such reform is based on the grounds that it would be much simpler to administer and much more equitable in operation than the present statutory framework. As can be seen from *Baker*, under certain circumstances almost any system that one could devise would be simpler to administer than the present one. This proposed system would do away with the primary problem faced by the court in *Baker*: No longer would there be a conflict between the timing rules of sections 312(a) and 316(a)(2), because there would no longer be a section 316(a)(2). As was pointed out in the discussion of Professor Rudick's proposal,<sup>59</sup> section 316(a)(2) has long outlived the reason for its existence. Moreover, since it provides for dividend tax-

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<sup>58</sup> It seems peculiar that the committee relied on the reasoning behind Professor Andrews proposal, which they rejected, as support for their rejection of the Rudick proposal. Andrews reasoned that the best indication that a distribution should be taxed as a dividend is that the corporation considers itself to be in a position to make the distribution.

<sup>59</sup> *Supra* note 51.

ation of the distributions of the current earnings of a deficit corporation, it is grossly inequitable in operation.

This proposal provides for the continued charge, under section 312(a), to the earnings and profits account of the amount of the distribution, or portion thereof in the case of redemption or partial liquidation, on the date of distribution, regardless of whether the distribution is ordinary or in redemption or partial liquidation. However, the balance of the account as of the date of distribution will not be ascertainable until the end of the tax year, when the entire gain or loss in earnings and profits can be calculated and spread throughout the year on a daily pro rata basis.

The proposal contains no separate "current" earnings and profits account and thus distributions will be taxed as dividends only if the corporation had a credit balance in the accumulated earnings and profits account at the time of distribution. Nor would returns of capital be taxed as dividends.

No priorities in the reduction of earnings and profits would be given to ordinary distributions; the only priority rule would be provided by section 312(a), which calls for the reduction of the earnings and profits account on the date of distribution. If redemption or partial liquidation distributions are made first in time, they would be given priority in reduction of the earnings and profits available at the date of distribution, calculated as of the end of the tax year.

Some advantages might still be gained by making distributions in redemption or partial liquidation prior to an ordinary distribution. This, however, would seem to be an opportunity that could be subjected to very little abuse because of the limited instances in which capital gains treatment is achieved under sections 302 and 346. These sections provide very inefficient tools for the effectuation of earnings and profits withdrawal at capital gains rates. Under section 302, unless someone is willing to have his equity interest in the corporation reduced substantially, or management forces a redemption on a minority shareholder, there would be little opportunity for abuse. In the latter case, if the redemption were entirely for the purpose of manipulating the earnings and profits account to benefit others upon subsequent ordinary distributions, an action would lie against the corporation or the board of directors in their individual capacities.

Section 346 provides even less opportunity for withdrawals of earnings and profits at capital gains rates because of the stringent set of requirements that must be met before its capital gains treatment is applicable.<sup>60</sup>

As for the two major arguments made by the Committee against the Rudick-type proposal which they were considering, only one of the arguments is available against this proposal. The Committee argument that the present statutory framework provides for greater ease in administration than does the one resulting from the mere deletion of section 316(a)(2) is not applicable to this proposal, which provides a rule for the determination of the amount of "accumulated" earnings and profits available on a certain date very similar to the one

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<sup>60</sup> INT. REV. CODE of 1954, § 346 defines those distributions which will be treated as partial liquidations and "not essentially equivalent to a dividend."

which section 316(a)(2) provides for such a determination in respect to "current" earnings and profits. In that particular respect, this proposal is just as simple to administer because of the provision for an arbitrary allocation of earnings and profits of the tax year on a pro rata daily basis; in other respects it is much simpler to administer because it does away with the priority problems faced in *Baker*.

Also, in a loss year, this arbitrary rule operates more equitably than does the present one since it provides less room for manipulation of the accumulated earnings and profits account. Under the present system, section 316(a)(2) becomes inapplicable and the "actual" balance of the account on the date of distribution is the amount against which the distribution must be measured.<sup>61</sup>

Finally, the Committee's argument that doing away with dividend taxation of distributions made out of current earnings and profits of a deficit corporation will create an artificial market in the shares of deficit corporations has little credence, and should be entitled to very little weight. This is especially true in light of the substantial advances that this proposal could make in the areas of simplicity and equitability of administration and operation of the "earnings and profits" and "dividend" provisions of the Internal Revenue Code of 1954.

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<sup>61</sup> See text accompanying notes 47-48 *supra*.