Some Earrings and Profits Aspects of the Internal Revenue Code of 1954

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I. Distributions in Kind

Until December 2, 1955, when the regulations interpreting subchapter C (except part V) were filed with the Federal Register, the battle over dividends in kind was fought on two fields, the 1939 Code and the 1954 Code. With the issuance of the regulations reflecting agreement by the Treasury Department with the general view that the proposed regulations were in error in applying the doctrine of the Hirshon\(^1\) and Godley\(^2\) cases to the provisions of the 1954 Code, the area of conflict regarding those cases has been narrowed to the question of their application under the 1939 Code. Possibly some day there may be a renewal of the issue over the 1954 Code provisions dealing with the problem but we are not presently concerned with this possibility, nor with the dispute as to years governed by the 1939 Code.\(^3\) For our purposes we shall assume that under the 1954 Code if the fair market value of the distributed property exceeds available earnings and profits the limit of dividend treatment to the shareholder is his pro rata share of the earnings and profits.\(^4\)

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\(^1\) Commissioner v. Hirshon Trust, 213 F.2d 523 (2d Cir. 1954), reversing 12 CCH Tax Ct. Mem. 364 (1953), cert. denied, 348 U.S. 861 (1954). Available earnings and profits were less than the fair market value of shares distributed by a corporation but greater than their "historical cost." It was held that the entire distribution was a "dividend" within the meaning of § 115(a) of the 1939 Code. The court found no inconsistency between charging only the cost to earnings and treating the fair market value as a dividend under § 115(j), reasoning that § 115(a) related to the nature of the distribution and § 115(j), quite independently, governed its valuation. In a dictum upon which the Commissioner has relied in more recent cases, the court implied that any distribution which does not "impair capital" is a dividend. 213 F.2d at 528.

\(^2\) Commissioner v. Estate of Godley, 213 F.2d 529 (3d Cir. 1954), reversing 19 T.C. 1082 (1953), cert. denied, 348 U.S. 862 (1954). Eleven days after the Hirshon decision, the Third Circuit, considering the same corporate distribution, reached a like result on the same theory.

\(^3\) For the earlier position of the Treasury see Proposed U. S. Treas. Reg. § 1.316-1(a) (2), (3), 19 Fed. Reg. 8253 (1954). There is a considerable body of literature on the problem. See Raum, Dividends in Kind: Their Tax Aspects, 63 Harv. L. Rev. 593 (1950); Molloy, Some Tax Aspects of Corporate Distributions in Kind, 6 Tax L. Rev. 57 (1950); Albrecht, "Dividends" and "Earnings or Profits," 7 Tax L. Rev. 157 (1952); Mintz and Plumb, Dividends in Kind—The Thunderbolts and the New Look, 10 Tax L. Rev. 41 (1954); Peterson, Subchapter C of the Internal Revenue Code of 1954—Corporate Distributions and Adjustments, 30 Notre Dame Law, 191 (1955); Kumler, Contributions and Distributions of Property in Kind to and by Corporations, 33 Taxes 938 (1955); Rubin, Tax Consequences of Dividends in Kind Since Godley, Hirshon and 1954 Code, 2 J. Taxation 7 (1955). All of these articles, except the Kumler article, were written before the Tax Court announced that it would not follow the decisions of the Circuit Courts in the Godley and Hirshon cases. The Tax Court's views were expressed in a clear and well reasoned opinion in Harry H. Cloutier, 24 T.C. No. 113 (1955). This case was followed in Dorothy B. Johnson, 14 CCH Tax Ct. Mem. 1121 (1955).

\(^4\) The regulations provide: "Where a corporation distributes property to its shareholders on or after June 22, 1954, the amount of the distribution which is a dividend to them may not exceed the earnings and profits of the distributing corporation." U.S. Treas. Reg. § 1.316-1(a) (2) (1955). The example in the regulation makes the interpretation crystal clear. Id. (3).
Unless a corporate distribution falls within one of the statutory exceptions it is treated as a dividend to the extent the distribution is out of the earnings and profits accumulated after February 28, 1913, or is out of earnings and profits of the taxable year. Any excess distribution is applied against and reduces the adjusted basis of the stock. If there is a further excess, it is treated as gain from the sale or exchange of stock, except that, to the extent such excess is out of increase in value accrued before March 1, 1913, it is exempt from tax.

These rules are, of course, similar to those employed in the 1939 Code.

If the distribution is in money, the amount of the distribution is, of course, the amount of money received. If the distribution is in other property and the shareholder is not a corporation, the general rule is that the amount of the distribution is the fair market value of the property.

If the distributee of the property is a corporation, the general rule is that the amount of the distribution is the lesser of the adjusted basis of the property to the distributing corporation or the fair market value of the property.

Whether the distributee of the property distribution is an individual or a corporation, the general rule for adjustment of earnings and profits of the distributing corporation is to reduce them by an amount equal to the adjusted basis of the property distributed. Special provisions are applicable in a number of cases and it is to them that we now turn.

Distributions of inventory assets. It is now expressly stated as a general rule that no gain or loss shall be recognized to a corporation on the distri—

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6 INT. REV. CODE of 1954, §§ 301(a), (c), 316. Section 316(a) defining “dividend”, contains the following sentence: “To 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.” This provision is apparently designed to make it clear, that where, in a particular provision of subchapter C, the rule is stated to be that the transaction shall be treated as a distribution of property to which § 301 applies, a dividend will result if the earnings and profits test of § 316(a) is met. In this connection see §§ 302(d), 305(b), 306(a) (2), 356(b), and 356(e). Section 316(b) provides that the term “dividend” in certain sections relating to dividends paid by insurance companies to policyholders shall not have the meaning assigned to “dividend” in § 316(a). Section 316(b) also enlarges the meaning of “dividend” to include certain personal holding company distributions. The provisions of § 316(b) are generally similar to provisions contained in § 115(a) of the 1939 Code.

§ 301(b).

7 INT. REV. CODE of 1954, § 301(c). Section numbers of the 1954 Code are hereinafter referred to simply by section number.

8 Ibid.

9 Ibid. Under § 115 of the 1939 Code no distinction was drawn between corporate and individual shareholders as to the amount of the distribution received. Under an amendment to § 26(b) of the 1939 Code, made by the Revenue Act of 1950, the corporate dividends received credit was based on treating the property distribution received by the corporate shareholder as a dividend in an amount not in excess of the adjusted basis of the property in the hands of the distributing corporation, increased in the amount of gain or decreased in the amount of loss recognized to the distributing corporation by reason of such distribution.

10 Ibid.

11 § 312(a).
bution with respect to its stock of its stock or property. There are three exceptions to the rule. If the property distributed consists of inventory assets, which are inventoried under the LIFO method, and the “inventory amount” of the assets “under a method authorized by section 471” exceeds the “inventory amount” under the LIFO method, the excess shall be treated as gain to the corporation recognized from the sale of the inventory assets.

The inventory amount is determined by treating the distribution date as if it were the close of the taxable year. The method “authorized by section 471” is the retail method, if the taxpayer employs the retail method of valuing inventories under section 472, or cost or market, whichever is lower, if the retail method is not used. This provision is, of course, a loophole closer and will prevent the use of a distribution to avoid the tax detriment of selling recent inventory acquisitions when such acquisitions have lower bases than earlier acquisitions.

If the market value of the distributed inventory exceeds its inventory amount after the adjustment, no tax is imposed on the excess, but an earnings and profits increase is required in such a case or in any inventory distribution if the fair market value of the inventory assets exceeds their adjusted basis. This increase is in addition to “the proper adjustment” to earnings and profits to be made if distributed inventory assets were inventoried under the LIFO method and gain was recognized to the corporation.

For purposes of illustration, assume a corporation distributes LIFO inventory assets inventoried at $50,000, having a FIFO basis of $75,000 and a fair market value of $90,000. The distribution will result in gain of $25,000 to the corporation. For earnings and profits purposes, the first step is to increase earnings by this $25,000. Since the fair market value of the inventory, $90,000, exceeds the basis as adjusted, $75,000, the earnings and profits must also be increased by the difference of $15,000.

For the purpose of this provision the term “inventory assets” is defined more broadly than under §311(b), relating to LIFO inventory distributions. Inventory assets for purposes of §311(b) include only “stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year.” Section 312(b) also includes property held by the corporation primarily for sale to customers in the ordinary course of the trade or business and unrealized receivables or fees, except receivables from sales or exchanges of assets described in the defining subparagraph. “Unrealized receivables or fees” is given a broad definition.

An interesting problem has been raised as to the effect of the distribution of a combination of appreciated and depreciated inventory. In Mintz and Plumb, Dividends in Kind—The Thunderbolts and the New Look, 10 Tax L. Rev. 41, at 71, 72, the authors suggest the following problem: “For example, a real estate subdivider may have one tract which has appreciated in value and another, badly located, whose value has decreased. Is the gross apprecia-
Upon the distribution, the earnings are decreased by $90,000, the fair market value of the assets, or, if $90,000 exceeds the earnings and profits of the corporation, by the earnings and profits.\textsuperscript{20} If the shareholder is an individual, the amount of the distribution is $90,000, the fair market value.\textsuperscript{21} If the shareholder is a corporation, the amount of the distribution is $75,000, the basis to the distributing corporation after the adjustment for the gain recognized.\textsuperscript{22} The basis of the property to the recipient will be the same as the amount of the distribution, $90,000 if the shareholder is an individual, or $75,000 if the shareholder is a corporation.\textsuperscript{23} If the shareholder receiving the distribution is a corporation and can sustain the position that the assets are capital assets in its hands, there is a limited area for tax avoidance remaining in the inventory distribution.\textsuperscript{24}

\textit{Distributions involving liabilities.} Under section 311(c), if a liability of the distributing corporation is assumed on distribution of property or if property is distributed subject to a liability, and the liability exceeds the basis, gain is recognized to the corporation. The rule is mitigated in the case of a distribution of property subject to a liability which is not assumed by the distributees by limiting the amount of gain recognized to the difference between the fair market value of the property and its basis even though the amount of the liability exceeds such value. In the case of an assumption of the liability, the corporation is apparently charged with gain in the full amount of the difference between the liability assumed and the basis, even though the fair market value of the property is less than the amount of the liability assumed.\textsuperscript{25} This rule appears to be applicable even in a case where the fair market value of the shareholder’s obligation to discharge the liability is not equal to the amount of the liability. The gain on a distribution involving liabilities is treated as if the property had

\footnotesize{\textsuperscript{20} § 312(b) (1).}
\footnotesize{\textsuperscript{21} § 301(b) (1) (A).}
\footnotesize{\textsuperscript{22} § 301(b) (1) (B).}
\footnotesize{\textsuperscript{23} § 301(d) ; U.S. Treas. Reg. § 1.301-1(h) (1955).}
\footnotesize{\textsuperscript{24} Under § 1223(2) the distributee corporation should be able to tack to its period of holding, the period during which the distributing corporation held the property, since the basis to the distributee is at least in part the same basis as the property had in the hands of the distributing corporation.}
\footnotesize{\textsuperscript{25} § 311(c).}
been sold so that if the property was a noncapital asset the gain will receive noncapital asset gain treatment.26

The amount of the distribution to an individual shareholder is the fair market value, reduced, but not below zero, by the amount of the liability assumed or the amount of the liability to which the property is subject. If the shareholder is a corporation, the amount of the distribution is the adjusted basis of the property to the distributing corporation increased by the gain recognized to the distributing corporation, and decreased by the liability as in the case of the individual shareholder.27

Section 312(c) provides that in making the adjustments to the earnings and profits of the distributing corporation otherwise provided in respect of the property distribution, proper adjustments shall be made for the liability involved and for any gain recognized to the distributing corporation. The regulations prescribe that the amount of any reduction in earnings and profits required on account of the property distribution shall be reduced by the amount of the liability to which the property was subject or by the amount of the liability assumed, and increased by the amount of gain recognized to the corporation on the distribution.28

Distributions of installment obligations. A distribution by a corporation of an installment obligation will result in the recognition of gain or loss.29 The exception is mentioned in section 311(a) but no provisions are included in the statute governing the effect on the shareholder. Concern has been expressed that a double tax might result if the shareholder is a corporation on the ground that the distributing corporation might have a recognized gain on the distribution and that, since the Code does not provide an exception, the basis to the corporate shareholder would be the same as the basis to the distributing corporation and the distributee corporation might therefore have income on any realization over such basis.30 There is a technical problem and the statute should be revised. It seems unlikely, however, that the Treasury Department will try to limit the distributee corporation to the basis of the obligation in the hands of the distributing corporation without adjustment for the gain recognized on the distribution.

There is no special provision relating to the adjustment of the earnings and profits of the distributing corporation on account of the distribution of an installment obligation. The correct adjustments would seem to be to adjust the earnings by the gain or loss recognized and to reduce the

27 § 301(b).
29 § 453(d). Exceptions are provided for distributions in connection with liquidations under § 332 and, to a certain extent, under § 337.
30 Peterson, op. cit. supra note 3, at 196, 197.
earnings by the basis of the obligation adjusted for the gain or loss recognized. Here again, the absence of any express provision, combined with the inclusion in the statute of specific provision in the case of other distributions where gain is recognized is troublesome and statutory clarification would be helpful.

**Distributions of obligations and stock of the distributing corporation.** The earnings and profits of a corporation distributing its obligations to shareholders are decreased by the principal amount of the obligations distributed.\(^3\) The amount of the distribution to the individual shareholders is the fair market value of the obligations distributed.\(^2\) There is a technical difficulty as to the corporate shareholder since, in the case of distributions of property other than money, the amount of the distribution to a corporate shareholder is, generally, the lesser of the fair market value of the property distributed or its adjusted basis to the distributing corporation.\(^3\) Obligations issued by a corporation to its shareholders as a distribution obviously have no basis to the issuing corporation. The regulations sensibly provide that the amount of the distribution to the shareholder corporation is the fair market value of the obligations distributed.\(^4\) In the limited instances in which a stock dividend constitutes an item of gross income, similar rules are used as in the case of the distribution of obligations.\(^5\)

**Distributions of property other than property specially treated.**\(^6\) If earnings and profits are adequate to cover property distributions the new provisions work in a reasonable way that should not cause any particular dissatisfaction. In cases where there is an insufficiency of earnings and profits, however, the results can be rather startling. The operation of the provisions can be understood by considering a series of examples.

**Example 1.** Corporation A, organized after February 28, 1913, has two shareholders, both individuals, each of whom owns one-half of the

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\(^3\) § 312(a). If the principal amount of the obligations exceeds the earnings and profits, the reduction serves, of course, only to eliminate the earnings and profits.

\(^2\) § 301(b) (1).

\(^4\) Ib id.


\(^6\) Stock dividends (including stock right distributions) are taxable if distributed in discharge of preference dividends for the current or preceding taxable year, or if the distribution is, at the election of any of the shareholders, payable either in stock (or rights to acquire stock), or in property. § 305(b). The regulations provide that if any portion of a stock dividend is includible in gross income the earnings shall be reduced by the fair market value of such portion. U.S. Treas. Reg. § 1.312-1(d) (1955). They also state that the amount of the distribution of a stock dividend of a taxable nature received by a corporate shareholder is its fair market value, and that the basis in such a case is the fair market value. U.S. Treas. Reg. § 301-1(d), (h) (1955).

\(^6\) For completeness, mention should be made that in a very limited type of payment by a foreign subsidiary, to the domestic parent, of property in the form of a royalty or compensation, the excess of the fair market value of the property over the cost of the property and services furnished by the domestic corporation is treated as a distribution by such foreign corporation to the domestic corporation. § 902(d).
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Example 2. The facts are the same except that the order of the distribution is reversed, the cash distribution preceding the property distribution. The cash distribution of $50,000 is a dividend, each shareholder receiving a dividend of $25,000. A balance of $50,000 remains in earnings and on the property distribution, therefore, each shareholder receives a dividend of $25,000 and since the $50,000 remainder of his distribution exceeds his basis of $40,000, he has a gain in respect of the stock of $10,000. It is assumed in all examples that the stock is a capital asset to the particular holder. The summary for each shareholder is then: dividends, $50,000, and capital gain, $10,000.

Example 3. The facts are the same except that Corporation A does not have any accumulated earnings and profits and has earnings and profits of the year of $100,000. Under section 316(a), as under section 115(a) of the 1939 Code, the earnings and profits of the taxable year are to be computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year and without regard to the amount of the earnings and profits at the time of the distribution. The order in time in which distributions of cash and property are made accordingly appears to be immaterial. The regulations do not state how distributions of property and money are to be combined for purposes of allocating earnings. They are limited to instructions for pro ration in the case of money.\(^7\) The amount of the distributions to each of the two shareholders is measured by the money or fair market value of the property received,

\(^7\) "If the distributions made during the taxable year consist only of money and exceed the earnings and profits of such year, then that proportion of each distribution which the total of the earnings and profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings and profits of that year." U.S. Treas. Reg. § 1.316-2(b) (1955). This regulation is substantially the same as that interpreting § 115(a) of the 1939 Code except that the words "consist only of money and" have been added. U.S. Treas. Reg. 118, § 39.115(b)-1(b) (1953).
and the pro ration rule seems to be a reasonable method here, too. On this basis, the part of each distribution which would be a dividend would be such proportion of the distribution as the earnings and profits of the year, $100,000, bore to total distributions of $200,000. The resulting fraction is one-half. The summary for each shareholder is then: dividends, $50,000 (one-half of $25,000, the money, plus one-half of $75,000, the fair market value of the property), and capital gain, $10,000 ($50,000, the excess of the distribution over the dividends, less $40,000, the basis of the stock).

Let us now consider the results if both shareholders are corporations, instead of two individuals.

*Example 1A.* Except as to the shareholders, the facts are the same as in Example 1, i.e., basis of stock to each shareholder, $40,000, accumulated earnings of $100,000, a distribution of property having an adjusted basis of $75,000 and a value of $150,000, and a subsequent cash distribution of $50,000. On the property distribution each shareholder would receive a dividend equal to one-half the adjusted basis, or $37,500. The earnings would also be reduced by the adjusted basis of the property, or $75,000, leaving $25,000 available for the second distribution. On the cash distribution of $50,000, each shareholder would have a dividend of $12,500, and the remaining $12,500 would be applied against basis. The summary for each shareholder is then: dividends, $50,000, and applied against basis, $12,500.

*Example 2A.* Except for the shareholders, the facts correspond to those in Example 2. It will be recalled that there is no difference between Examples 1 and 2 except that in the latter the cash distribution precedes the property distribution. On the cash distribution, each shareholder will receive a dividend of $25,000, leaving a balance of $50,000 of available earnings. On the property distribution, each shareholder will receive a dividend of $25,000, and the remaining $12,500 of the distribution will be applied against basis. The summary for each shareholder is then: dividends, $50,000, and applied against basis, $12,500.

*Example 3A.* Except for the shareholders, the facts are similar to those in Example 3. Corporation A, in this example, has no accumulated earnings but earnings of the current year of $100,000. The total amount of the distributions is $125,000, consisting of money of $50,000, and property with an adjusted basis to Corporation A of $75,000. It would seem that the proper formula should be to treat $100,000/125,000 or 4/5 of the distributions as dividends and the remaining 1/5, or $25,000, as recovery of the shareholders’ bases. The summary for each shareholder is then: dividends, $50,000, and applied against basis, $12,500.

Finally, we come to consider the case where an individual owns one-half of the stock and a corporation the other half.
Example 1B. Except for the shareholders, the facts are similar to those in Example 1. Here the accumulated earnings are $100,000 and the property distribution precedes the cash distribution. On the property distribution, the amount of the distribution received by the individual shareholder is $75,000, one-half the value of the property, and the amount of the distribution received by the corporate shareholder is $37,500, one-half the adjusted basis of the property to Corporation A. The total, $112,500, exceeds the available earnings and profits of $100,000. Each shareholder has received the same property distribution but the amounts of the distributions to the two shareholders differ. We are here in virgin territory with the Committee reports and the regulations offering no aid in the determination of the amount of the dividend received by each shareholder. It is rather difficult to suggest any formula except to treat as a dividend such proportion of the distribution received by each shareholder as the available earnings, $100,000, bear to the total distributions received by both shareholders, $112,500. The individual then has a dividend of $75,000, or $66,667, and applies against basis the balance, or $8,333. The corporate shareholder then has a dividend of $37,500, or $33,333, and applies against basis the balance, or $4,167. The distribution reduces earnings by $75,000, leaving $25,000 available. On the subsequent cash distribution each shareholder receives a dividend of $12,500 and applies the balance of the distribution, $12,500, against basis. The summary is then: the individual shareholder receives dividends of $79,167, and applies against basis $20,833; the corporate shareholder receives dividends of $45,833, and applies against basis $16,667.

Example 2B. Except for the shareholders, the facts are similar to those in Example 2. The accumulated earnings are $100,000 and the cash distribution precedes the property distribution. Each shareholder receives a dividend of $25,000 on the cash distribution and there remain earnings and profits of $50,000. The total amount of distributions received by the shareholders on the property distribution is again $112,500. Applying the formula suggested in Example 2A, the amount treated as a dividend to each shareholder is such proportion thereof as available earnings, $50,000, bear to total distribution, $112,500. The fraction treated as a dividend would then be 4/9 of the amount received. In the case of the individual shareholder, the dividend is 4/9 of $75,000, or $33,333, and the amount to be applied against basis is $41,667. Since the latter exceeds the shareholder's basis of $40,000 for the stock, he has a capital gain of $1,667. The dividend received by the corporate shareholder is 4/9 of $37,500, or $16,667 and the amount to be applied against basis is $20,833. The summary is then: the individual shareholder has dividends of $58,333 and
a capital gain of $1,667; the corporate shareholder receives dividends of $41,667 and applies against basis $20,833.

**Example 3B.** Except for the shareholders, the facts are similar to those in Example 3. There are no accumulated earnings and the earnings of the year are $100,000. The total distributions to the shareholders amount to $162,500, consisting of $75,000 in property and $25,000 in cash to the individual, and $37,500 in property and $25,000 in cash to the corporate shareholder. Applying the rules developed in the other examples, it would seem that 100,000/162,500, or 8/13 of the amount of the distributions to each shareholder is a dividend. The individual shareholder then has dividends of 8/13 of $100,000, or $61,538, and applies against basis the difference of $38,462. The corporate shareholder has dividends of 8/13 of $62,500, or $38,462, and a recovery of basis of the difference of $24,038.

The following table summarizes the dividend and capital gain results of the foregoing examples:

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The examples used so far have assumed only accumulated earnings or only current earnings. Although additional complications are presented by a combination of accumulated earnings and current earnings, it appears that if individual shareholders are involved, the order of timing effect noted in the above examples will probably be similar although not as pronounced.\(^\text{38}\)

\(^{38}\)For purposes of illustration assume the same facts as in Example 1 (only individual shareholders involved) but that Corporation A has accumulated earnings of $50,000 and earnings of the year of $50,000. The first distribution is the property distribution. Under the method generally followed in the regulations, if both accumulated and current earnings are involved, and are inadequate, the current earnings are prorated over the year's distributions and to the extent they are inadequate to cover the distributions, the accumulated earnings are used against the first distribu-
The distributions described in the examples involve distributions of appreciated property. In one respect at least different considerations are presented by the distribution of depreciated property. Since the amount of the distribution to a corporate shareholder may not exceed fair market value of the distributed property, both an individual shareholder and a corporate shareholder will receive, if depreciated property is distributed, the same amount of distribution, that is, an amount equal to fair market value. The distortion in treatment observed in the appreciated property cases, to the extent that it is caused by combining individual and corporate shareholders, is therefore absent in the depreciated property cases. Since, in all cases, the reduction of earnings and profits differs from the amount of the distribution if depreciated property is distributed, the order of timing of such a distribution and of a cash distribution may affect the amounts taxable as dividends, whether the shareholders are individuals, corporations or a combination of both.

The foregoing examples and discussion suggest the formulation of certain rules that appear to be applicable if property having a value different from its adjusted basis to the distributing corporation is distributed and earnings and profits are inadequate to cover distributions:

1. If the distributing corporation has accumulated earnings and profits, the order of timing of the distribution of property which has a value in excess of its adjusted basis and of other distributions may affect the amounts of the distributions treated as dividends, if the shareholders are all individuals or are individuals and corporations. If, however, the shareholders are corporations only, the order of timing in such cases would seem to be immaterial.

2. If the distributing corporation has accumulated earnings and profits, the order of timing of the distribution of property which has a value less than its adjusted basis and of other distributions may affect the amount.
of the distributions treated as dividends, whether the shareholders are individuals, corporations or both.

(3) If only earnings and profits for the taxable year are involved, the order of timing of the distribution of property, whether appreciated or depreciated in value, and of other distributions would appear to have no bearing on the amounts of the distributions treated as dividends.

(4) If the property distributed has a value in excess of its adjusted basis and there are individual and corporate shareholders, it would appear that the amounts of the distribution or distributions treated as dividends to each individual shareholder will exceed the amount which would be so treated if there were no corporate shareholders, and the amounts treated as dividends to each corporate shareholder will be less than the amounts which would be so treated if there were no individual shareholders. If, however, the property distributed has a value less than its adjusted basis, it is immaterial, in determining the amounts treated as dividends, whether the shareholders are individuals or corporations.

In the examples upon which these suggested rules are based, relatively simple fact patterns have been used. Compare with the problems in such cases the problems presented if a publicly held corporation, with perhaps thousands of shareholders, is involved. Such a corporation may distribute stock owned by it which has appreciated in value, or may distribute rights to purchase such stock. Is the distributing corporation under an obligation to comb its stock list and work out a formula based upon a determination of the number of shares owned by individuals and the number owned by corporations?

It is to be noted that of the two problems discussed, the timing problem and the distortion caused by treating individual and corporate shareholders differently, the latter is more troublesome. Timing, at least, is usually subject to control. In adopting the new rule that generally the amount of a distribution of property received by a corporate shareholder may not exceed the adjusted basis of the property in the hands of the distributing corporation, the Congress was eliminating the unsatisfactory amendment of the 1950 Act which treated the distribution to the corporate shareholder as the fair market value but limited the dividends received credit in respect of the distribution to the basis in the hands of the distributing corporation. This limitation operated in all cases where any part of the distribution was made out of earnings and profits. The new provision presents a problem only if earnings and profits are insufficient. Nevertheless, it is unsatisfactory

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89 The distribution involved in the Godley and Hirshon cases involved stock of another corporation.

40 See supra note 10.
in such cases, and further statutory revision may ultimately result. One possible approach would be to use fair market value as the amount of the distribution in the case of corporate shareholders except as to a corporate shareholder owning more than a certain percentage of the stock of the distributing corporation and as to such a shareholder to use the present limitation to basis rule. Another alternative, of course, would be to adjust earnings and profits for the appreciation or depreciation in value and to charge earnings and profits with the fair market value of the property distributed. For purposes of determination of the allocation of earnings and profits, each shareholder might be deemed to receive as the amount of the distribution the fair market value of the distribution received, but for purposes of inclusion in gross income the corporate shareholders could be treated as receiving only the basis to the distributing corporation of the property distributed. Neither approach is free from difficulty and further consideration of the whole problem seems to be in order.

II. Earnings and Profits Increase in Connection With Government Loans

The background of section 312(j) and the decision of the Tax Court in George M. Gross are too well known to require more than brief description. Upon completion of the construction of certain housing developments, the Gross-Morton corporations found themselves with proceeds of Federal Housing Administration insured loans exceeding the costs of the housing developments which secured the loans. Accordingly, distributions greatly exceeding any earnings and profits of the corporations were made to shareholders. The shareholders treated the excess of the distributions over earnings and profits and the bases of the stocks of the corporations as capital gains, relying upon section 115(d) of the 1939 Code. Upon disclosure of the facts before the Senate Banking Committee, the Senate Finance Committee promptly reacted by adding to the 1954 Code, then in the legislative process, that odd mélange of legal theories, section 312(j), applicable to distributions made on or after June 22, 1954. In addition, an amendment was made to the collapsible corporation provision. Approximately

42 For a more detailed description, see Lurie, The Messrs. Gross and Morton: Modern '49ers, 33 Taxes 666 (1955), and Mintz and Plumb, op. cit. supra note 3, at 77.
43 § 341 (a) (3). This provision expressly treats as gain from the sale or exchange of a noncapital asset gain from "a distribution made by a collapsible corporation which, under § 301 (c) (3) (A), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property." This provision codifies the regulation issued under the 1939 Code. U.S. Treas. Reg. 118, § 89.117(m)-1(a), (e) Example (1) (1953). That regulation was probably a proper construction of the statute. MacLean, Collapsible Corporations—
one year after the passage of the 1954 Code, the Tax Court in a well reasoned
decision in the Gross case adopted the taxpayers' view of section 115(d)
of the 1939 Code. The Tax Court rejected the Commissioner's argument
that petitioners had failed to show that the distributions "impaired capital"
and, accordingly, that section 115(c) was inapplicable. It remains to be
seen whether, on appeal, the Second Circuit will impose the extreme limita-
tions on the operation of section 115(d) that the Commissioner suggests.

For an adjustment to be required under section 312(j) three conditions
must exist. They are:

(1) a distribution by the corporation in respect of its stock,
(2) an outstanding loan to the corporation, made, guaranteed, or
insured by the United States, or an agency or instrumentality of the United
States, and
(3) the amount of such loan must be in excess of the adjusted basis
of the property constituting security for such loan.44

The statute requires an upward adjustment of earnings and profits
by the excess of the loan over the basis of the property and, immediately
after the distribution, a decrease in earnings and profits by such excess.
For purposes of the third condition described above, the adjusted basis of
the property at the time of distribution is to be determined without regard
to any adjustment under section 1016(a)(2) (relating to adjustment for
depreciation, depletion, etc.).

Although section 312(j) reflects Congressional reaction to a specific
fact situation, the Gross-Morton type of case, it is not so limited by its terms.
For example, a publicly held corporation is engaged in manufacturing both
directly and through subsidiaries. It undertakes a large defense contract
and in order to finance the work it borrows from banks. Part or all of the
loan is guaranteed by the United States. The loan is secured by a pledge
of stocks of subsidiaries which have substantial values but low bases in the

The Statute and Regulations, 67 Harv. L. Rev. 55, 84 (1953); Mintz and Plumb, op. cit. supra
In Thomas Wilson, 25 T.C. No. 120 (1956) and W. H. Weaver, 25 T.C. No. 121 (1956), both
of which involved distributions by construction companies with outstanding FHA loans, the
Commissioner contended that the gain resulting from sale and redemption of stock received by
shareholders was taxable as ordinary income under § 117(m), the collapsible corporation provision
in the 1939 Code. The Tax Court rejected the argument on the ground that the Commissioner
had not established all of the facts which are prerequisite to the application of the statute, thereby
leaving open the question of law.

The Senate Finance Committee Report indicates that § 341(a)(3) of the 1954 Code is
primarily directed at the Gross-Morton situation and the elimination of the language difficulty
in applying old § 117(m) to a distribution of the character involved in the Gross-Morton case.
S. Rep. No. 1622, 83d Cong., 2d Sess. 260 (1954). In view of the application of § 312(j) it is not
clear that the collapsible corporation amendment is necessary or even particularly helpful in
this type of case.

44 A commitment to make, guarantee, or insure a loan is treated as the making, guaranteeing,
or insuring of a loan.
hands of the parent. Upon a distribution by the parent, are its earnings and profits subject to section 312(j) adjustments? The statutory language would clearly seem to require an affirmative answer and the language of the Senate Finance Committee indicates an intent to provide a broad coverage. Such a result does not seem justified. The loan is an ordinary operating loan and if the borrower is in a sound enough position to be permitted under the terms of the loan to pay dividends, the amounts distributed should be subject to the usual rules applied in determining tax treatment.

The provision by its terms appears to require the special earnings and profits adjustments each time a distribution is made without regard to the taxability of previous distributions. This view has been adopted in the regulations. The failure to take into account the effect that a prior adjustment may have had in rendering a distribution taxable as a dividend, when it would otherwise have been a capital transaction, must be attributed to the penal nature of section 312(j) unless, of course, it is simply an oversight in draftsmanship.

Surely the drafting technique leaves much to be desired. The statute does not provide that the distribution will be a dividend to the extent of the excess of the loan over the adjusted basis of the property. Rather, the statutory scheme is to increase earnings and profits and determine the dividend status by simply taking the adjustment into account. Unless the distribution is out of earnings and profits, either accumulated or current, there is no provision which would require treatment as a dividend. Never-

45 "It is intended that the subsection shall apply with respect to a loan made, guaranteed, or insured by any agency or instrumentality of the United States, including the Federal Housing Administration." S. Rep. No. 1622, 83d Cong., 2d Sess. 251 (1954).

46 The same might be said to some extent, at least, in the housing cases but there is a distinction. In the latter cases the theory of the borrowing is for the specific purpose of constructing housing and, presumably, the housing corporations engage in no business activities except the erection and operation of the housing developments. The proceeds of the loans in the defense loan case have no connection with the assets pledged.

47 The regulations give the following example of the operation of § 312(j):

"Example. Corporation A borrowed $1,000,000 for the purpose of construction of an apartment house, the cost and adjusted basis of which was $900,000. This loan was guaranteed by an agency of the United States Government. One year after such loan was made and after the completion of construction of the building (but before such corporation had received any income) it distributed $100,000 cash to its shareholders. The earnings and profits of the taxable year of such corporation are increased (pursuant to section 312(j)) by $100,000 immediately prior to such distribution and are decreased by $100,000 immediately after such distribution. Such decrease, however, does not reduce the earnings and profits below zero. Two years later, it has no accumulated earnings and has earnings of the taxable year of $100,000. Before it has made any payments on the loan, it distributes $200,000 to its shareholders. The earnings and profits of the taxable year of the corporation ($100,000) are increased by $100,000, the excess of the amount of the guaranteed loan over the adjusted basis of the apartment house (calculated without adjustment for depreciation). The entire amount of each distribution is treated as a distribution out of earnings and profits and, accordingly, as a taxable dividend." U.S. Treas. Reg. § 1.312-12(b) (1955).
theless, the Senate Finance Committee stated that "in no case may an accumulated deficit in earnings and profits of the corporation be used to reduce the increase in earnings and profits to be made" under section 312(j). The statutory basis for the statement is not clear. Some support for the position may be found in the provision that, in determining the increase, the adjusted basis of the property without adjustment for depreciation (or the other adjustments of section 1016(a)(2)) must be used. An accumulated deficit in earnings and profits would normally reflect depreciation adjustments, and if such a deficit were to be allowed as an offset to the increase in earnings, the proper basis of the property, to effect the purpose of the statute, would presumably be the basis after adjustment for depreciation. On the other hand, if section 312(j) creates a separate pocket of earnings, the language adopted was not very apt.

A related problem would be presented in the following type of case: Corporation A has a loan meeting the conditions of section 312(j), the amount of which exceeds the basis of the property securing the loan by $200,000. The corporation, with accumulated earnings and profits of $100,000, distributes $100,000, thereby requiring an increase in earnings and profits of $200,000 pursuant to the statutory scheme. Immediately after the distribution, earnings and profits must be decreased by $200,000. Should there also be a decrease in earnings and profits of $100,000 on account of the dividend? The usual concept of earnings and profits would seem to contemplate such a decrease. Section 312(j) is silent on the point, however, and the Senate Finance Committee Report indicates that there should be no decrease.

Additional problems are suggested by section 312(j). Enough has been said, however, to suggest the desirability of a legislative revision. It is believed that such a revision should not only eliminate the technical problems that now exist and bring the subsection within the general framework of the distribution provisions of the Code but also limit the area to which section 312(j) applies.

III. Earnings and Profits and Deficits in Tax-Free Reorganizations and Liquidations

Surprisingly, since the Supreme Court's decision in Commissioner v. Phipps there has been only one important case passing upon the effect of

48 S. Rep. No. 1622, 83d Cong., 2d Sess. 251 (1954). The regulations do not mention the point but it would be consistent with the example given that the increase in earnings and profits was not reduced by a deficit in earnings and profits. U.S. Treas. Reg. § 1.312-12 (1955).

49 The Senate Finance Committee Report states: "To the extent that any distribution exceeds the excess of the loan over the adjusted basis, earnings and profits not arising out of the increase herein provided may be decreased, and if no other earnings and profits are available, the capital may be decreased." S. Rep. No. 1622, 83d Cong., 2d Sess. 251 (1955).

50 See Lurie, op. cit. supra note 42, at 669, 670.

51 336 U.S. 410 (1949).
a tax-free reorganization or liquidation on the earnings and profits of the corporate parties to the transaction. The reference is to United States v. Snider, which gave effect to a predecessor's deficit in computing earnings and profits of the successor. It will be recalled that the Phipps case involved the tax-free liquidation of subsidiaries under section 112(b)(6) of the Revenue Act of 1936. One of the subsidiaries had some earnings and profits but the other subsidiaries had very substantial deficits in their earnings and profits accounts and the issue was as to whether these deficits reduced the earnings and profits of the parent. The Supreme Court held that the rule of Commissioner v. Sansome, that a successor in a tax-free reorganization acquires the earnings and profits of the predecessor, "is grounded not on a theory of continuity of the corporate enterprise but on the necessity to prevent escape of earnings and profits from taxation." The Court concluded that it would be contrary to Congressional intent and beyond the rationale of the Sansome case to permit the parent the advantage of the losses sustained by the subsidiaries.

The soundness of the opinion has been questioned and it has been argued that, in any event, it did not follow from the Phipps case that deficits of transferors in tax-free reorganizations and liquidations should be completely ignored. It was suggested that the deficits might be "allowed as offsets against future accumulations of earnings and profits of the continuing corporation." The distinction between the effect on accumulated and subsequent earnings was recognized by the Court of Appeals for the First Circuit in the Snider case. A Massachusetts trust owned two Boston hotels, the Braemore and the Kenmore. In 1947 it was decided to reorganize and establish two new corporations, one to own and operate the Braemore and the other to own and operate the Kenmore. The trust transferred the Braemore to a new corporation, Hotel Braemore Corporation, in exchange for stock. The shares of the trust were then exchanged for stock of the Hotel Kenmore Corporation, another new corporation. The trust was liquidated, and the Hotel Kenmore Corporation acquired all the assets of the trust, consisting of the Kenmore and the stock of Hotel Braemore Corporation. At the time of these transactions the trust had a deficit in earnings and profits of approximately $327,000.

For the next several years the Hotel Kenmore Corporation operated at a profit of about $140,000 and in 1950 it distributed $36,000, of which...
the taxpayer received $9,000. The current earnings were a little more than $20,000, sufficient to cover approximately $5,100 of the $9,000 received by the taxpayer. The Commissioner determined that the remaining $3,900 was also paid out of earnings and profits. The District Court held for the taxpayer, pointing out that, although under the Phipps rule a tax-free reorganization would not deprive the government of dividend tax to which it would otherwise have been entitled, there was nothing in the Phipps case that required a holding that the government should gain by the process.  

The Court of Appeals for the First Circuit affirmed, saying:

"Thus, the Supreme Court seems to emphasize the possession by one of the business entities involved in the tax-free reorganization of accumulated earnings and profits at the time of the reorganization. The non-existence of such earnings and profits in the instant case clearly distinguishes it from the Phipps case. We consequently hold that a logical application of the Sansome rule, even as that rule has been defined by the Supreme Court in the Phipps case, compels us to conclude that in determining whether distributions made to its stockholders by the Hotel Kenmore Corp. are dividends, the deficit of its real estate trust predecessor must be taken into account."  

As pointed out by the District Court in the Snider case, the 1954 Code adopts, in the tax-free reorganization area, the distinction drawn in the Snider case between application of a deficit against subsequent earnings and reduction by a deficit of existing accumulated earnings.  

For purposes of discussion of the rules established by the 1954 Code, two general divisions have been used, the allocation of earnings and profits in corporate separations, and the treatment of earnings and profits in corporate liquidations and reorganizations not involving separations.

A. Earnings and Profits in Corporate Separations

In the form adopted by the House of Representatives, H.R. 8300 contained specific provisions as to the allocation of earnings and profits in corporate separations. This approach was not accepted by the Senate Finance Committee and section 312(i) provides that "proper allocation with respect to the earnings and profits of the distributing corporation and the controlled corporation (or corporations) shall be made under regulations prescribed by the Secretary or his delegate." The authors of the portion of the Senate Finance Committee Report dealing with section 312(i), how-

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68 224 F.2d at 168.
69 125 F.Supp. at 353.
70 § 381(c) (2).
71 The provisions were contained in § 310(c) of the House Bill. For a discussion of them, see H.R. REP. No. 1337, 83d Cong., 2d Sess. A95, A96 (1954).
ever, set forth a considerable number of the rules applicable\textsuperscript{62} and these rules, with additions, have been incorporated in the regulations.\textsuperscript{63}

For the purposes of the rules, the regulations divide corporate separations under section 355 into two general categories, the first, involving the transfer of assets to another corporation in a section 368(a)(1)(D) transaction followed by a distribution of the stock and securities of the controlled corporation in a distribution or exchange to which section 355 applies,\textsuperscript{64} and the second, section 355 distributions or exchanges not in pursuance of a plan meeting the requirements of a reorganization as defined in section 368(a)(1)(D).\textsuperscript{65} The regulations provide, as to the first category, that in the case of a newly created controlled corporation, the allocation of earnings and profits generally shall be made in accordance with the relative fair market values of the businesses and other interests in properties in the two corporations immediately after the transaction. "In a proper case," however, "allocation shall be made between the distributing corporation and the controlled corporation in proportion to the net basis of the assets transferred and of the assets retained or by such other method as may be appropriate under the facts and circumstances of the case." For this purpose, "net basis" means the basis of the assets less the liabilities assumed or liabilities to which such assets are subject.

The regulations provide that if the separation does not involve a section 368(a)(1)(D) transaction the earnings and profits shall be decreased by the lesser of the following amounts:

(1) The amount of decrease which would have been effected if the distributing corporation had transferred the stock of the controlled corporation to a new corporation in a section 368(a)(1)(D) transaction and immediately thereafter distributed the stock of the new corporation, or,

(2) The "net worth" of the controlled corporation, defined to mean the sum of the bases of the properties plus cash minus all liabilities.

If the earnings and profits of the controlled corporation immediately before the transaction are more than the amount of the decrease in earnings and profits of the distributing corporation, they shall remain unchanged. In all other cases, the earnings and profits of the controlled corporation, after the transaction, shall be equal to the amount of the decrease in the distributing corporation's earnings and profits.


\textsuperscript{63}U.S. Treas. Reg. § 1.312-10 (1955).

\textsuperscript{64}Of course, the transaction could not in any event qualify as a § 368(a)(1)(D) transaction unless at least sufficient stock were distributed to constitute control under § 368(c) (stock possessing 80 per cent of voting power, and 80 per cent of total number of shares of all other classes of stock). §§ 368(a)(1)(D), 355(a)(1)(D).

\textsuperscript{65}For simplification, there has been omitted from the summary of the regulation mention of transactions falling within so much of § 356 as relates to § 355. Such transactions are included. U.S. Treas. Reg. § 1.312-10 (1955).
Whether the transaction falls into the first or second category, no part of a deficit of a distributing corporation is permitted to be allocated to a controlled corporation.

Any formula for allocation of earnings and profits in separation cases may result in strange results in a particular application. Probably the most accurate method of allocating would be to analyze the earnings and profits account, or accounts, in order to determine the source of the earnings and profits, to review the history of the businesses involved, and then to make an allocation in the light of all the facts. Such an approach is not practical and the methods prescribed in the regulations seem, on the whole, reasonable. The fair market value relationship should give the closest approximation to relative earning powers of the businesses. This would not be so, necessarily, if the assets involved included substantial properties in addition to the businesses. Furthermore, the allocation is of earnings already realized and may not represent an accumulation in any manner reflecting contributions by the businesses in ratio to their current fair market values. Where it can be established, however, that the fair market value method does not work fairly, the regulations are broad enough to permit the use of another method. It might be difficult to sustain the legal right to another method in the face of the Commissioner's opposition, unless it were shown that the use of a fair market value method led to clearly improper results.

It is to be noted that the regulations, in prescribing the general rule of fair market values in cases falling within the first category (transfers in section 368(a)(1)(D) transactions), refer only to newly created corporations. The proposed regulations contained no such reference. It may be that the change was made in contemplation of the possibility of a separation involving a transfer of assets under section 368(a)(1)(D) to an existing controlled corporation followed by the distribution of the stock of the controlled corporation. There is no specific provision for allocation in such a case and apparently there would be used either the net basis of assets method or such other method (including a fair market value method) "as may be appropriate under the facts and circumstances."

A separation may take place, of course, during the taxable year of the distributing corporation. In this event there are two classes of earnings and profits of the distributing corporation to consider, the accumulated earnings at the beginning of the taxable year and the earnings and profits of the taxable year. In discussing cases involving section 368(a)(1)(D) transactions, the regulations state:

"The part of the earnings and profits of the taxable year of the distributing corporation in which the transaction occurs allocable to the controlled

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corporation shall be included in the computation of the earnings and profits of the first taxable year of the controlled corporation ending after the date of the transaction.\textsuperscript{67}

Presumably the regulation contemplates that the earnings and profits of the distributing corporation will be computed to the date of the distribution and if, as so computed, there are earnings and profits of the taxable year to such date an allocated part of such earnings will be added to the earnings of the controlled corporation for the taxable year. The general rule of section 316 is to make a dividend determination on the basis of the current year's earnings and profits at the close of the year without reference to distributions during the year. Following this rule, the distributing corporation's earnings and profits of the current year so determined would be decreased by the amount of the earnings and profits of the taxable year allocated to the controlled corporation.

If the separation distribution is of stock of an existing corporation it is at least theoretically possible to reduce the allocation of earnings and profits to the controlled corporation by its payment of a dividend to the distributing corporation prior to the distribution. Such a dividend would reduce the value of the assets or, if basis of assets were used, the amount of basis of assets of the controlled corporation, and, therefore, the percentage of earnings and profits to be allocated to the controlled corporation. The increase in the distributing corporation's earnings and profits resulting from the dividend would constitute a partial offset to the decrease in the controlled corporation's share of the assets.

Another point peculiar to a case involving a distribution of an existing corporation is suggested by the provision in the regulation that even if there is a deficit in earnings and profits of the controlled corporation, its earnings and profits after the distribution shall be equal to the decrease of the distributing corporation's earnings. Nothing is said about the use of the deficit to offset subsequent earnings and profits and it must be assumed that the offset is not allowed by the regulation. This approach conforms with the Senate Finance Committee Report.\textsuperscript{68} Why such a limitation should be imposed is not clear. It seems inconsistent with the theory of section 381 which permits deficits of acquired or acquiring corporations in certain tax-free liquidations and reorganizations to offset subsequent earnings and profits of the acquiring corporation.

A rule which denies the allocation of a deficit to a controlled corpora-

\textsuperscript{67} U.S. Treas. Reg. § 1.312-10(a) (1955).

\textsuperscript{68} "In no case shall the earnings and profits of the controlled corporation after the distribution be less than the amount by which the earnings and profits of the distributing corporation are decreased." S. Rep. No. 1622, 83d Cong., 2d Sess. 250 (1954).
tion in all separation transactions also seems of questionable soundness. In promulgating the regulation to this effect, the Treasury Department again followed the Senate Finance Committee Report. In an appropriate case, an allocation to a newly formed corporation of part of the distributing corporation’s deficit would seem proper. Assume, for example, a slight change in the facts of the Snider case. A corporation owning two separate hotels in different cities, each of which has operated at a loss, transfers one hotel to a newly created corporation and, in a transaction qualifying under section 355, distributes the stock of the new corporation. If economic realities are to be recognized, is there any reason for requiring the distributing corporation to retain the entire deficit and to deny the offset of any part of the deficit against the subsequent earnings of the hotel that in fact incurred a share of the deficit? It is true that ascertainment of the source of a deficit may be difficult and it could hardly be assumed that the two businesses contributed to the deficit in direct proportion to the fair market value, or the net basis, of their assets. It is submitted that this difficulty is not sufficiently great to close the door on any allocation of a deficit to a controlled corporation. In the light of the Senate Finance Committee Report and the regulations it must be anticipated that no such allocation will be allowed unless section 312(i) is amended to provide express regulatory authority for allocation of a deficit to a controlled corporation in an appropriate case.


Interestingly enough, the taxpayer corporation in Senior Investment Corporation, 2 T.C. 124 (1943), settled and remanded pursuant to agreement of parties, 47-1 U.S.T.C. Par. 9180 (6th Cir., Feb. 5, 1947), allocated a deficit in earnings and profits between itself and a corporate transferee in a tax-free transaction of part of its assets on the basis of relative fair market values of assets retained and transferred. The transaction took the form of the organization of a new corporation, the transfer of assets to it and the distribution of its stock to the stockholders of the transferor. Under the 1954 Code, if the transaction could qualify for tax-free treatment it would be a section 355 separation. One issue in the case was the right of the transferor to a credit, as a deficit corporation, for undistributed profits tax purposes, under § 26(c)(3) of the Revenue Act of 1936, as amended by the Revenue Act of 1942. Subsequent to the transaction the transferor had realized some earnings and profits and the Commissioner claimed that the transferor was not a deficit corporation. If he could have established an allocation of the entire deficit to the transferee, the Commissioner would have won on the issue. The Tax Court held that it was clear that, even if the Commissioner’s argument that certain additional assets transferred should be taken into account in the allocation should be accepted, the transferor’s deficit more than offset subsequent earnings. For further discussion of this case see Lyons, op. cit. supra note 56, at 17, note 32 and at 20. As there pointed out, the Supreme Court in the Phipps case, after describing the Senior Investment Corporation case said, 336 U.S. at 418 in footnote 13, that the question of inheritance of a deficit was not in issue.

81 An argument can be made that in § 381(c)(2) transfers of deficits in earnings and profits in certain liquidation and reorganization transactions were expressly provided for and that by failing to mention deficits in § 312(i) there is no power granted to the Secretary or his delegate to allocate deficits in § 355 transactions. This is a narrow construction in the light of the different form of the two sections and, without the statement in the Senate Finance Committee Report, it would seem that this construction should not be adopted.
B. Earnings and Profits in Tax-Free Liquidations and Reorganizations Not Involving Separations

Earnings and profits and deficits in earnings and profits are among the items which may be carried over to successors in transactions described in section 381. The transactions so described include a complete liquidation of a subsidiary which is tax-free to the parent corporation under section 332, except in a case in which the basis of the assets is determined under section 334(b)(2), relating to liquidations within two years of purchase. There are also included transfers to which section 361, relating to nonrecognition of gain or loss to corporations, applies but only if the transfer is in connection with a reorganization described in certain designated subparagraphs of section 368(a)(1). Among the designated subparagraphs are (A), statutory merger or consolidation, (C), acquisition by one corporation in exchange for voting stock of substantially all the properties of another corporation, and (F), a mere change in identity, form or place of organization. The other reorganization subparagraph designated is (D), a transfer by a corporation of assets to another corporation if control is in the transferor or its shareholders, but a subparagraph (D) reorganization is included only if the requirements of section 354(b)(1) are met. These requirements are that the transferee corporation acquire substantially all the assets of the transferor and that the transferor distribute pursuant to the plan of reorganization the stock and securities received in the exchange and all other properties owned by the transferor. The limitation as to subparagraph (D) reorganizations eliminates a (D) reorganization in connection with a separation. The carry-over of earnings and profits in separations is, of course, covered by section 312(i), previously discussed.

The general rule of section 381 is that the acquiring corporation succeeds to and takes into account, as of the close of the day of distribution or transfer, the items described in section 381(c) of the distributor or transferor corporation, subject to the limitations and conditions described. One condition is that, except in a section 368(a)(1)(F) reorganization, the taxable year of the distributor or transferor corporation ends on the date of distribution or transfer.

The provisions relating to the carry-over of earnings and profits are

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71 § 381(b). This subsection prescribes the date of distribution or transfer as the day on which the transfer or distribution is completed, except that, under regulations, the date when substantially all of the property has been distributed or transferred may be used if the distributor or transferor ceases all operations, other than liquidating activities, after such date. Subsection (b) also contains a limitation applicable only to the carryback of a net operating loss.
contained in subsection (c)(2). The general rule is that the earnings and profits, or deficit in earnings and profits, of the distributor or transferor corporation are deemed to be received or incurred by the acquiring corporation as of the close of the date of transfer. A deficit of the distributor, transferor or acquiring corporation, however, may be used only to offset earnings and profits accumulated after the date of transfer or distribution. For this purpose, the earnings and profits for the taxable year of the acquiring corporation in which the distribution or transfer occurs are deemed to be accumulated after such distribution or transfer in an amount which bears the same ratio to the undistributed earnings and profits of the acquiring corporation for such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.\textsuperscript{74}

Regulations have not yet been issued under section 381 and the principal guide at this time is in the Committee reports. Since the House version of section 381 was changed in some respects, the Senate Finance Committee Report will be used for reference.

Probably the most interesting feature of paragraph (c)(2) is the treatment of deficits. The approach is consistent with the factual situation of the Phipps case which involved the effect on accumulated earnings of the parent of the deficits of the liquidated subsidiaries. The approach is also consistent with the Snider case (which may have been influenced by section 381(c)(2)) in permitting the deficit of a party to the transaction to offset subsequent earnings. On the whole, this treatment of deficits in section 381 represents a reasonable solution of a difficult problem and, provided the safeguards against abuse of section 381 prove adequate, should be satisfactory to the Treasury Department.\textsuperscript{75} The rules stated in the Senate Finance Committee Report with respect to deficits are only such as are largely self-evident from the terms of paragraph (c)(2).\textsuperscript{76}

\textsuperscript{74} Paragraph (2)(B) states that the undistributed earnings and profits of the acquiring corporation for the taxable year shall be computed without regard to any earnings and profits received from the distributor or transferor corporation, as described in subparagraph (A). The concept is somewhat confusing. The computation of the portion of the earnings and profits of the acquiring corporation deemed to be accumulated after the distribution or transfer is for the purpose of offset by the loss of one of the parties to the transaction. The loss obviously cannot be the loss of the acquiring corporation and must be the loss of the distributor or the transferor. There would then be no earnings and profits of the distributor or transferor that could be taken into account. Conceivably, two or more distributors or transferors could be involved, one or more with deficits and the others with accumulated earnings.

\textsuperscript{75} Whether the safeguards against abuse of § 381 are adequate is beyond the scope of this paper. For more general discussion of § 381 see Cohen et al., The Internal Revenue Code of 1954: Carry-overs and the Accumulated Earnings Tax, 10 TAX. L. REV. 277 (1955); Roshe, Carry-Overs in Corporate Adjustments Under the 1954 Code, 32 TAXES 1018 (1954); Kramer, Carry Forward Tax Benefits of Acquired Corporations, N.Y.U. 13TH INST. ON FED. TAX. 741 (1955).

\textsuperscript{76} S. REP. No. 1622, 83d Cong., 2d Sess. 279, 280 (1954). The rules stated in the Report emphasize the limitations on the use of deficits except against subsequent earnings and profits. The Report also explains the method of prorating the earnings and profits of the acquiring
The Report states that in no case shall any earnings and profits of the distributor or transferor corporation be considered a part of the earnings and profits of the first taxable year of the acquiring corporation ending after the date of distribution or transfer. Reliance for this interpretation appears to be placed chiefly on the provision of section 381(b) that, except in a subparagraph (F) reorganization, the taxable year of the transferor or distributor ends on the date of distribution or transfer. From this provision the conclusion is drawn that the earnings and profits of the transferor or distributor are determined on the basis of accumulations from February 28, 1913, to the date of distribution or transfer and go over to the acquiring corporation to become part of the earnings and profits of the latter accumulated since February 28, 1913. The Report also refers to section 316(a) in support of the Committee position although it is not clear that the provisions of section 316(a) add any strength.

Problems of the application of section 381(c)(2) have arisen in certain Groman and Bashford type reorganizations. To remove, in part at least, the restrictions imposed by the Groman and Bashford cases and the decisions which have followed the rules there laid down, there was added to section 368(a)(2) subparagraph (C) which provides that a transaction otherwise qualifying under paragraph (1)(A), a statutory merger or consolidation, or paragraph (1)(C), acquisition by a corporation for voting stock of substantially all the properties of another corporation, shall not be disqualified by reason of the fact that part or all of the assets which were acquired in that transaction are transferred to a corporation controlled by the corporation acquiring such assets. There is also included in section 368(a)(1)(C) a provision that “voting stock of a corporation which is in control of the acquiring corporation” may be used.

Corporation for the taxable year of acquisition so that the deficit of the transferor or distributor may offset the post-acquisition part. The Report prescribes the use of the deficit against succeeding years' earnings in the order in which they occur. If both the acquiring corporation and the transferor or distributor have deficits they are to be combined into the deficit of the acquiring corporation. Although the Report does not so state, presumably the Treasury Department will construe the law as requiring that each subsequent year's earnings be reduced first by distributions before application of the carry-over deficit.


the new provisions have limited the Groman and Bashford rules remains uncertain. For our purposes, however, we can consider certain transactions which are clearly within the new provisions.

Corporation W transfers all its assets to Corporation S in exchange for voting stock of Corporation P, which owns all the stock of Corporation S. Corporation W dissolves and distributes the stock of Corporation P to stockholders. Under the language of section 381 (as well as that of section 368(a)(1)(C)) Corporation S surely seems to be the acquiring corporation and should, it is believed, succeed to the earnings and profits of Corporation W.

Assume a similar transaction except that the assets of Corporation W are first acquired by Corporation P and are then, and as part of the original plan, transferred to Corporation S in exchange for stock of the latter. Will Corporation W's earnings and profits remain with Corporation P or do they follow the assets into Corporation S? The Treasury Department is normally interested, of course, in keeping earnings and profits at the highest level of a corporate tier. In the proposed regulations under subchapter C it was provided that if property is transferred by one corporation to another corporation within the provisions of section 351, relating to tax-free transfers of property to controlled corporations, no allocation of earnings and profits should be made between the transferor and transferee by reason of such transfer. This general provision was not limited and the view of the Treasury Department apparently was that in the assumed factual situation the earnings and profits of Corporation W would remain with Corporation P.

An argument can be made that the "acquiring corporation" for the purpose of section 381 is Corporation P. In section 368(a)(2)(C), the provision eliminating the effect of the Groman-Bashford rules in the transaction under discussion, reference is made to the transfer of the assets acquired "to a corporation [Corporation S] controlled by the corporation acquiring such assets [Corporation P]." On the other hand, there is no requirement that "acquiring corporation" in section 381 be read as governed by such a provision in section 368. The better approach would be to read section 381 so as to give a consistent treatment to transactions that are similar in substance. Corporation S should be the acquiring corporation whether it acquired the assets in form from Corporation W or Corporation P.


83 It is assumed in this case and those discussed subsequently that the usual business purpose requirements are met.

The Treasury Department in the regulations issued under subchapter C appears to be leaning in the direction of considering the earnings as following the assets into Corporation S even though the assets first passed through Corporation P. After the sentence providing for nonallocation of assets between transferor and transferee in section 351 transactions the following has been added:

"The preceding sentence may not apply when such transfer immediately follows or immediately precedes either a reorganization under section 368 or a liquidation under section 332 to which section 334(b)(2) does not apply."

The provision is noncommittal but one area in which it should be applied is the type of transaction under discussion. Other types of cases involving similar questions could be considered but it is believed that enough has been said to indicate the problems. The key really lies, it is submitted, in a decision that in the first fact situation suggested the earnings and profits of Corporation W go to Corporation S on a direct transfer to it of assets of Corporation W for stock of Corporation P. Unless the earnings can be deemed to become Corporation P’s earnings in that case it is hard to justify making them earnings of Corporation P where the assets are destined for Corporation S from the beginning even though they are temporarily in Corporation P.

It is to be hoped that when regulations are issued construing section 381 they will adopt a consistent pattern for the Groman-Bashford type reorganizations along the lines suggested. Presumably, as earnings go, so will go deficits, subject, of course, to the special rules applicable to deficits.

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66 Although no policy has been announced on the subject, it is understood that in one or more appropriate cases determinations have been made by the Treasury Department that the earnings of the acquired corporation follow the assets through to the subsidiary.