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Richard L. Doernberg

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THE ACCUMULATED EARNINGS TAX: THE RELATIONSHIP BETWEEN EARNINGS AND PROFITS AND ACCUMULATED TAXABLE INCOME IN A REDEMPTION TRANSACTION

RICHARD L. DOERNBERG*

INTRODUCTION

Differences in individual and corporate tax rate structures create an often irresistible temptation to use corporations as a shield against the individual income tax.[1] Congress recognized this temptation as early as 1913 and moved to eliminate it by taxing the shareholders of offending corporations.[2] The successor to the early legislation is today's accumulated earnings tax,[3] which is levied against the corporation itself.

Internal Revenue Code section 532(a) applies the accumulated earnings tax to corporations that accumulate earnings and profits beyond an amount needed to meet reasonable business needs in order to avoid the individual income tax.[4] If section 532(a)'s requirements are met, section 531 imposes a penalty on accumulated taxable income, which is defined as taxable income with specified adjustments less the dividends paid and the accumulated earnings credit.[5] Differing measures for triggering the tax, known as the "triggering measure," and for computing the liability, known as the "base measure," can prompt the accumulated earnings tax to be applied in a most peculiar situation: when there is no accumulation of current earnings.

To those familiar with the Code it is not surprising that the accumulated earnings tax can be levied on a corporation that has distributed all of its earnings and profits for the period at issue. To illustrate: *X* Corporation, a calendar year taxpayer, formed in 1950, has one million dollars of accumulated earnings and profits as of December 31, 1978. There are no further accumulations in 1979 or 1980. In 1981, *X* has $200,000 of earnings and profits from operations

*Assistant Professor of Law, Emory University School of Law. B.A., 1970, Yale; M.A.T., 1972, Wesleyan University; J.D., University of Connecticut; LL.M., 1980, New York University.

1. B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS § 95.1.1 (1981).
2. Tariff Act of 1913, Pub. L. No. 16, § II, 38 Stat. 114, 116 (1913).
3. I.R.C. §§ 531-37 (1976).
4. I.R.C. § 532(a) (1976) reads:

> The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

Id.

5. *Id.* § 535(a). In years after 1981 the minimum accumulated earnings credit is increased from $150,000 to $250,000 except for certain service corporations. *See id.* § 535(c)(2)-(3) (West 1982).

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that it uses to redeem one shareholder's stock, leaving no current earnings.[6] Thus in 1981, *X* has not accumulated any earnings and, depending on the circumstances, may have actually distributed prior earnings. *X* may nevertheless find itself with an accumulated earnings tax liability. Under existing law redeeming a single shareholder's stock does not reduce accumulated taxable income even though the redeeming corporation's earnings and profits are reduced.[7]

Rather than focusing upon arguments concerning whether profit accumulation is justified in particular cases, this article examines two issues, the analysis of which may render justification analysis unnecessary.[8] The first issue is whether current earnings and profits are necessary to trigger the accumulated earnings tax provisions. The second issue, which has been largely unexamined is whether redemptions are distributions that qualify for the dividends paid deduction and thereby reduce accumulated taxable income.[9] In a situation where a redemption reduces current earnings and profits to zero, a determination either that the accumulated earnings tax is inapplicable or that the redemption distribution also reduces the applicable tax base obviates consideration of whether the use of current earnings for redemption has a reasonable business purpose.

REDEMPTIONS TO AVOID ACCUMULATED EARNINGS TAXATION: CONTRASTING JUDICIAL VIEWS

GPD, Inc. v. Commissioner[10] is the leading case in the area. In *GPD*, the

6. Under I.R.C. § 312(e) (1976) the proper charge to capital account is the pro rata portion of contributed capital allocable to the redeemed shares. *See* Helvering v. Jarvis, 123 F.2d 742 (4th Cir. 1941); Rev. Rul. 376, 1979-2 C.B. 133.

7. One commentator has suggested taxing accumulated taxable income only to the extent of current earnings and profits. Neither statute nor case law supports this interpretation. *See* Note, *The Computation of Earnings and Profits for Purposes of the Accumulated Earnings Tax*, 20 TAX L. REV. 733, 739 (1965). For an energetic debate over the proposal, see Edelstein, *Earnings and Profits and the Accumulated Earnings Tax*, 23 TAX L. REV. 419 (1968); Edelstein, *Earnings and Profits and the Accumulated Earnings Tax: A Further Dissent*, 23 TAX L. REV. 423, 425 (1968) [hereinafter cited as *A Further Dissent*]; Sitrick, *Earnings and Profits and the Accumulated Earnings Tax: A Reply*, 23 TAX L. REV. 420, 421 (1968).

I.R.C. § 535 (1976) which defines accumulated taxable income refers to the dividends paid deduction in § 561. Section 561(b) incorporates the rules of § 562. Section 562(b) does permit certain liquidation distributions including partial liquidations to qualify for the dividends paid deductions. Section 346(a) treats a redemption under § 302 as a partial liquidation for purposes of I.R.C. § 562(b). *See* Treas. Reg. § 1.561-1(b) (1960). I.R.C. § 562(c) (1976), however, limits the dividends paid deductions to nonpreferential, pro rata distributions. Treas. Reg. § 1.562-2(b) (1960) Ex. 2 clearly states the Service's position that a redemption involving less than all of the shareholders will be deemed preferential.

8. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 8.01-.09 (4th ed. 1979); Herwitz, *Stock Redemption and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866 (1961).

9. I.R.C. § 562(c) (1976). While § 562(c) requires distributions to be "pro rata, with no preference" to qualify for the dividends paid deduction, those terms are not defined. *Id.*

10. 508 F.2d 1076 (6th Cir. 1974), *rev'g* 60 T.C. 480 (1973). For a discussion of *GPD*, see Rudolph, *Stock Redemptions and the Accumulated Earnings Tax—An Update*, 4 J. CORP.

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sole GPD, Inc. shareholder periodically donated highly appreciated stock to various charities, securing for himself sizeable charitable deductions while avoiding taxation on the stock's appreciation.[11] Subsequent to the charitable transfer, the corporation would redeem the stock the charitable donees held in a tax-free transaction because the donees were tax-exempt organizations.[12] After determining that GPD had allowed its earnings and profits to accumulate beyond the reasonable needs of the business in 1967 in order to eliminate the sole shareholder's individual tax liability, the Tax Court assessed the accumulated earnings tax for 1967.[13] For the 1968 tax year, however, the court found that the redemptions reduced GPD's current earnings to zero, thereby precluding imposition of the tax.[14]

The Sixth Circuit reversed the Tax Court, finding that the legislative history underlying the accumulated earnings tax indicated current earnings were not a prerequisite for imposition of the tax.[15] Having made that determination, the court concluded the redemption was not pro rata within the meaning of section 562(c) and therefore could reduce GPD's accumulated taxable income.[16]

The problem raised by *GPD* is not isolated. It arose before that case[17] and has surfaced again recently in *Lamark Shipping Agency, Inc. v. Commissioner*[18] when the Service imposed the accumulated earnings tax for a year in which the corporation had distributed all its current earnings in the form of a redemption. The taxpayer neglected to raise the current earnings issue.[19] Nevertheless, the Tax Court *sua sponte* recognized the Sixth Circuit's approach in *GPD*, but then refused to reexamine that "fairly nettlesome legal issue." While *GPD* is the law in the Sixth Circuit, the Tax Court pointedly noted it is "not constrained" to follow decisions appealable to other circuits.[20] The court thus avoided the threshold issue of whether the accumulated earnings tax should be applied and turned to the question of justification, examining whether the hypothetical accumulation of current earnings exceeded Lamark's reasonable business needs for the year in question.[21]

TAX 101 (1977); Comment, GPD, Inc. v. Commissioner: *Closing a Loophole in the Accumulated Earnings Tax*, 70 NW. U.L. REV. 651 (1975).

11. 60 T.C. at 485.
12. *Id.* at 485-86.
13. *Id.* at 487, 496.
14. *Id.* at 491.
15. 508 F.2d at 1087.
16. *Id.*
17. *See, e.g.*, Ostendorf-Morris Co. v. United States, 26 A.F.T.R.2d (P-H) ¶ 70,5369 (N.D. Ohio 1968) (relied on heavily by the Sixth Circuit in *GPD*).
18. 1981 T.C.M. (P-H) ¶ 81,284.
19. Instead the taxpayer tried to prove that the redemption was reasonable, thereby justifying the accumulation. *See* I.R.C. §§ 532 (1976), 537 (1976 & Supp. III 1979).
20. 1981 T.C.M. (P-H) at ¶ 81,974. *See* Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.) *cert. denied*, 404 U.S. 940 (1971).
21. *Id.*

THE NECESSITY OF CURRENT EARNINGS TO IMPOSE THE ACCUMULATED EARNINGS TAX

It is difficult to understand how there can be accumulated earnings tax liability for a year in which there are no earnings accumulated, merely because there were accumulated earnings derived in prior years, some of which may be closed under the statute of limitations.[22] Consider *X* Corporation formed in year one. In each of its first ten years *X* does well, increasing its earnings each year and reinvesting most of those earnings. During these years the Service does not challenge the accumulations as unreasonable. After a successful eleventh year, *X* uses all of its current earnings to redeem the holdings of one of its shareholders. The redemption decreases the current earnings and profits account to zero.[23] If the accumulated earnings in years one through ten were not considered unreasonable in years one through ten, why do the same earnings suddenly become unreasonable in year eleven, a year in which there are no additional current earnings? While prior earnings and profits may have a bearing on whether accumulation of current earnings is unreasonable,[24] re-evaluation of past accumulated earnings and profits when there are no current earnings and profits results in an unlimited statute of limitations for assessing the accumulated earnings tax.[25]

The Tax Court in *GPD* concluded that absent any current earnings and profits, the accumulated earnings tax could not be imposed.[26] The court relied on *American Metal Products Corp. v. Commissioner*,[27] in which the taxpayer's

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22. *See* I.R.C. § 6501 (1976 & Supp. III 1979).

23. *See supra* note 6.

24. *See* Treas. Reg. § 1.535-3(b)(1)(ii) (1960).

25. Commentators who view current earnings alone as a triggering measure include: S. WEITHORN & R. NOALL, THE ACCUMULATED EARNINGS TAX §§ 4.23(6), 7.1 at 96-97 & 129-31 (1968); Edelstein, *supra* note 7, at 419; Sitrick, *supra* note 7, at 421; Pomeroy, *Accumulations and Distributions of Earnings and Profits*, 17 W. RES. L. REV. 717, 721-22 (1966); Herwitz, *supra* note 8, at 932.

With this view in mind, a number of commentators have recommended the use of redemptions to reduce current earnings and profits to zero, thereby avoiding the earnings tax. *See, e.g.*, Huffaker, *Redemption of Stock to Pay Estate Taxes: Techniques of Pay-out*, N.Y.U. 25TH INST. ON FED. TAX. 963, 979 (1967); Levithan, *Defensive Planning to Avoid the 531 Tax — Some Techniques to Use*, 26 J. TAX'N 88, 92 (1967); Pomeroy, *supra*, at 721-22.

26. 60 T.C. at 491.

27. 34 T.C. 89 (1960), *aff'd*, 287 F.2d 860 (8th Cir. 1961).

The Tax Court decisions in both *GPD* and *American Metal* relied on two previous decisions that are supportive, but are not direct authority. In W.S. Farish & Co. v. Commissioner, 38 B.T.A. 150 (1938), *non acq.*, 1938-2 C.B. 43, *aff'd*, 104 F.2d 833 (5th Cir.), *cert. denied*, 308 U.S. 559 (1939), the Board of Tax Appeals noted: "Taxable net income is purely a statutory concept, and bears no necessary relation to gains and profits subject to distribution as dividends . . . . The proscribed act is the accumulation of 'gains and profits' [now earnings and profits] and not 'net income.'" *Id.* at 158. In *Farish*, though, the issue was the proper method of accounting for property transferred to the corporation in what is now a § 351 exchange. The Board of Tax Appeals held that the cost of an asset for computing earnings and profits might differ from the cost for computing taxable income. *Id.* In Corporate Investment Co. v. Commissioner, 40 B.T.A. 1156 (1939), *non acq.*, 1940-1 C.B. 6, the Court commented:

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accumulated earnings and profits declined slightly in the year in question as a result of the payment of a prior year's assessment of the accumulated earnings tax. The tax payments eliminated the current earnings and profits but did not affect accumulated taxable income.[28] *GPD* followed the conclusion in *American Metal* that the absence of current earnings and profits prevented application of the tax in that year, notwithstanding that the surplus was still unreasonable.[29]

The Sixth Circuit's reversal in *GPD* was based on two arguments, one legislative and one statutory, neither of which is satisfactory. The court first exhaustively examined the legislative history of the accumulated earnings tax provisions, trying to prove that current earnings are not a requirement. After examining the legislative history, the court examined the statutory provisions themselves. Both of these arguments will be examined in turn.

Legislative History of the Accumulated Earnings Tax

There is no indication that applying the accumulated earnings tax with-

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> The use of the words "to accumulate" instead of some such phrase as "to remain accumulated" is significant. Earnings of prior years may remain accumulated during the year but are not permitted "to accumulate" during that year. If Congress had intended to penalize the corporation for accumulating a surplus in prior years or for failing to distribute such a surplus in the taxable year, it would hardly have measured the penalty by the earnings of the current year or relieved the corporation from the penalty upon condition that the earnings of the current year were distributed to or reported by the stockholders.

Id. at 1172 (footnote omitted). However, the Court in *Corporate Investment* ruled for the taxpayer not because there was an absence of current earnings and profits, but because no improper motivation was found to exist in connection with earnings that were accumulated. *Id.* at 1176.

28. Payment of the accumulated earnings tax does not reduce taxable income in computing accumulated taxable income. I.R.C. § 535(b)(1) (1976); Treas. Reg. § 1.535-2(a)(1) (1960).

29. *American Metal*, 34 T.C. at 104. The Tax Court's view is more pointedly articulated in Eastern Mach. Co. v. Commissioner, 1951 TAX CT. MEM. DEC. (P-H) ¶ 51,312, where the court stated:

> The penalty surtax was not meant to be imposed upon a corporation because it failed to distribute a surplus accumulated in prior years . . . . Rather, it is applicable only to the case where there has been an accumulation during the taxable year of that year's current earnings and profits in excess of the reasonable needs of the business, the purpose being to avoid the levying of a surtax upon the shareholders.

Id. at ¶ 51,957. *See also* United Bus. Corp. of Am. v. Commissioner, 33 B.T.A. 83 (1935); Charleston Lumber Co. v. United States, 20 F. Supp. 83 (D. W. Va. 1937).

The Tax Court has, however, been guilty of loose language on at least one occasion. In Ted Bates & Co. v. Commissioner, 1965 T.C.M. (P-H) ¶ 65,251, a corporation redeemed stock held by a 70% founder of the corporation. Although the court found that the redemption was for a sound business purpose, it also seemingly rejected the taxpayer's contention that the redemption absorbed all the earnings and profits thereby making the tax inapplicable. *Id.* at 1495-96. When confronted with its *Ted Bates* decision in *GPD*, the Tax Court dismissed this interpretation, noting that in fact the redemption in *Ted Bates* had not wiped out all the current earnings and profits and that the redemption qualified for a dividends paid deduction on other grounds. *GPD*, 60 T.C. at 493 n.7.

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out regard to current earnings ever occurred to legislators.[30] Indeed, when section II(A)(2) of the Tariff Act of 1913 was enacted, a corporation's unreasonable "gains and profits"[31] were taxed directly to the shareholders. Accordingly, no disparity existed between the triggering measure and the base measure.[32] Moreover, redemptions warranted no special treatment in the 1913 Act.[33] Like any other distribution out of current earnings and profits, redemptions constituted a shareholder dividend while corporate earnings and profits were decreased accordingly.[34]

While the Revenue Act of 1916 did not affect the accumulated earnings tax provisions,[35] the Revenue Act of 1918 did make a subtle alteration that escaped congressional discussion. The triggering measure remained "gains and profits," but the base measure of the tax became the corporation's net income.[36] Nevertheless, at this point in the legislative history, a corporate distribution served to decrease both the triggering measure and base measure so that it was impossible for a corporation to have no current gains and profits and still have a large tax base. In defining the scope of the 1918 Act, the Service stated that the accumulated earnings tax is prospective and "can not be utilized to force a distribution of unnecessary surplus accumulated in prior years."[37] It prior accumulations could trigger the tax the Service would have applied the 1918 Act to prior accumulations which corporations failed to distribute after 1918.

30. For a comprehensive review of the operation and economic impact of the accumulated earnings tax provisions, see JOINT COMM. ON THE ECON. REP., THE TAXATION OF CORPORATE SURPLUS ACCUMULATIONS, 82d Cong., 2d Sess. 200-05 (Comm. Print 1952). The report does not discuss the relationship of redemptions to the accumulated earnings tax and does not consider any situations where prior earnings and profits trigger a tax on a current tax base.

31. The term "gains and profits" remained in the accumulated earnings tax provisions until enactment of the Revenue Act of 1936, when the term "earnings and profits" was substituted with no intent to change existing law. S. REP. No. 2156, 74th Cong., 2d Sess. 17, 1939-1 C.B. (pt. 2) 678, 689.

32. Nevertheless, the Sixth Circuit strongly relies on a dialogue between Senators Borah and Williams during the Senate debate as supporting its view. *GPD*, 508 F.2d at 1083-84. The dialogue does not address the issue.

33. It should be noted that redemptions were relatively uncommon transactions at this point in corporate history. *See generally* Herwitz, *supra* note 8, at 866-99; Wormser, *The Power of a Corporation to Acquire its Own Stock*, 24 YALE L.J. 177 (1915) (contrasting the English and American rule concerning the right of a corporation to redeem its shares). The term "redemption" did not enter the tax statutes until 1921. *See* Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 227, 228-29.

34. *See, e.g.*, Revenue Act of 1916, § 31(a), added by ch. 63, § 1211, 40 Stat. 337 (1917). To the extent that a redemption was not made from earnings but instead was a distribution of the capital stock account, the recipient would remain subject to the accumulated earnings tax provisions. *See* O.D. 360, 2 C.B. 25 (1920).

35. *See* Revenue Act of 1916, ch. 463, § 3, 39 Stat. 756, 758.

36. Under Revenue Act of 1918, ch. 18, § 220, 40 Stat. 1057, 1072, the shareholders were to be taxed in the same way as shareholders of personal service corporations. Thus, the shareholders were accountable for their respective shares of any net income that was not distributed by the corporation during the taxable year. *See* Revenue Act of 1918, ch. 18, § 218(e), 40 Stat. 1057, 1070. *See also* Treas. Reg. 45, § 218, art. 325 (1918).

37. O.D. 188, 1 C.B. 182 (1919). The inexact and interchangeable use of "income" and "surplus" suggests that the base amount and the triggering amount were viewed as equivalents.

In 1921, in response to judicial doubt concerning the constitutionality of taxing shareholders for the accumulated earnings of a corporation, Congress shifted the incidence of the tax from the shareholders to the corporation.[38] The trigger remained gains and profits and the base remained net income. Unlike the 1918 Act, however, the net income base under the 1921 Act was not decreased by amounts the corporation distributed to shareholders.[39] Theoretically, under the 1921 Act, a distribution could decrease current gains and profits to zero without diminishing the corporation's net income.[40] Congress did not consider the propriety of using prior accumulated profits in such situations to trigger the tax. The Service, however, amplified its 1918 ruling and declared that past accumulations were considered relevant only in assessing the reasonableness of any current accumulation of gains and profits and would not be used to trigger a tax on net income.[41]

The Revenue Act of 1924 provided redemptions special preference. The statute included in its definition of "amounts distributed in partial liquidation" distributions "in complete cancellation or redemption of stock" and provided exchange treatment for such partial liquidations, thereby allowing capital gains status for redemptions.[42] Moreover, section 201(c), the progenitor of

38. Revenue Act of 1921, ch. 136, § 220, 42 Stat. 227, 247-48. *See* Eisner v. Macomber, 252 U.S. 189 (1920). In *Eisner,* the Supreme Court held a stock dividend issued by Standard Oil Company was not "income" for purposes of the 1916 Revenue Act or the constitutional requirement that income taxes be apportioned equally among the states. *Id.* at 210-12. *See* U.S. CONST. amend. 16. The Court examined the accumulated earnings of a corporation and indicated that if distribution were mare by cash dividend this would be shareholder income that the 1916 Act may tax in an unconstitutional manner. 252 U.S. at 212-16.

39. *Compare* Revenue Act of 1921, ch. 136, §§ 232-34, 42 Stat. 227, 254-57 *with* Revenue Act of 1918, ch. 18, § 218(e), 40 Stat. 1070. If the shareholders under the Revenue Act of 1921 elected to be taxed as partners, their share of net income would reflect distributions in the same manner as under the 1918 Act. *See* Revenue Act of 1921, ch. 136, §§ 218(a), 42 Stat. 227, 245 & 247.

40. An indication of this potential can be found in an example by an early commentator: "If a corporation held liable [under § 220] had received in the taxable year profits of $800,000 . . . and if $400,000 had been distributed as dividends to its shareholders, the statute would levy the 50 per cent tax on the total $800,000 of income." Wood, *Corporations Which Are Subject to a Punitive Tax Rule,* 3 TAXES 55 (1925). For a discussion of the distinction between "net income" and "earnings and profits," see Charles F. Ayer v. Commissioner, 12 B.T.A. 283, 287 (1928) (decided under the 1921 Act).

41. I.T. 1572, II-1 C.B. 139 (1921). *See also* HOLMES, FEDERAL TAXES 262 (6th ed. 1925).

42. *See* Revenue Act of 1924, ch. 234, §§ 201(g) (defining "partial liquidation"), 201(c) (providing exchange treatment), 208(b) (setting a 12½% maximum tax on capital gains), 43 Stat. 253, 255, 263.

For a brief period from 1918 to 1921, § 201(c) of the Revenue Act of 1918 provided that liquidating distributions received exchange treatment, but no reference was made to either partial liquidations or redemptions. There is no indication that during this period redemptions were treated any differently from dividends. *See* Hellmich v. Hellman, 18 F.2d 239 (8th Cir. 1927) (gain realized in liquidation treated as dividend); Frank Darrow v. Commissioner, 8 B.T.A. 276 (1927) (distributions in liquidation to extent of accumulated earnings are dividends).

The 1924 Act also eliminated the election available to shareholders under the 1921 Act to include their distributive share of the corporation's net income in their individual returns. The elimination of the option was an effort to enhance enforcement. S. REP. No. 398, 68th Cong., 1st Sess. 26, 1939-1 C.B. (pt. 2) 266, 284.

current section 312(e), provided that the portion of the redemption proceeds not chargeable to the corporation's capital account constituted a distribution of earnings and profits.

It was theoretically possible under the 1924 Act for a corporation to distribute all of its current profits in a redemption that provided capital gains treatment to the shareholders while eliminating the corporation's current gains and profits but not its net income.[43] There is no hint in the legislative history that Congress was concerned with the bailout potential of the redemption on corporate earnings and profits. Even before the 1924 Act it was possible to extract corporate earnings and profits by allocating a preferential dividend to a shareholder in a low tax bracket. Such a transaction would decrease earnings and profits without affecting the corporation's net income.[44] After 1924, the bailout could be accomplished at a capital gains rate to shareholders; however, there is no indication that because of capital gains treatment to shareholders corporations were to be judged on accumulated earnings of years prior to the one in question.[45]

Congress was concerned that as a result of the 1924 Act shareholders would, through the mechanism of pro rata redemptions, try to convert ordinary dividends into more favorable capital gains or even nontaxable returns of capital.[46] Consequently, the Revenue Act of 1926 provided that any redemption which was essentially equivalent to a dividend[47] would be treated as a

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43. It is not clear that the 1924 Act envisaged non-pro rata redemptions at all. *See* James D. Robinson v. Commissioner, 27 B.T.A. 1018, 1021-22 (1933), *aff'd*, 69 F.2d 972 (5th Cir. 1934).

44. *See supra* note 40.

45. Under I.R.C. §§ 562(b) & 346(a) (1976) it is clear that redemptions satisfying the pro-rata requirements of § 562(c) decrease not only earnings and profits, but also the base measure for the accumulated earnings tax. *See also id.* § 535(c). This suggests that availability of capital gains treatment to shareholders is unrelated to whether prior earnings and profits trigger the tax in the first instance. *See also* H.R. REP. No. 2475, 74th Cong., 2d Sess. 11 (1936) where under the 1936 Act the tax base for applying the accumulated earnings tax was reduced by distribution even if the recipients were exempt from taxation.

46. An illustrative example appearing consistently in the 1926 committee reports states:

> Assume that two men hold practically all the stock in a corporation, for which each had paid $50,000 in cash, and the corporation had accumulated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders, for cash, one-half of the stock held by them and cancel it without making the stockholders subject to any tax. Yet this action, in all essentials, would be the equivalent of a distribution through cash dividends of the earned surplus.

H.R. REP. No. 1, 69th Cong., 1st Sess. 5 (1926); S. REP. No. 52, 69th Cong., 1st Sess. 15 (1926); H.R. REP. No. 356, 69th Cong., 1st Sess. 30 (1926). The reports went on to say that § 201(g) of the Revenue Act of 1926 was intended to make clear that such a distribution would be taxable as a dividend. *Id.*

47. Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 9, 11. The "essentially equivalent" language of § 201(d) finds its origin in § 201(d) of the Revenue Act of 1921. Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 227, 228-29. Congress recognized that on the strength of Eisner v. Macomber, 252 U.S. 189 (1920), nontaxable stock dividends might be issued and then redeemed as a substitute for ordinary cash dividends. Section 201(d) provided that a redemption after the distribution of such a stock dividend could be taxed if "essentially equivalent" to a

dividend. This change was intended to ensure that as a condition to capital gains treatment, distributions by redemption involved the surrender of some significant equity interest. The Revenue Act of 1926 also reinstated the shareholder's option of having the corporation's net income, whether distributed or not, taxed directly to the shareholder rather than subjecting the corporation to the accumulated earnings tax.[48]

In 1927, the Joint Committee on Internal Revenue Taxation issued a comprehensive report on the enforcement of the accumulated earnings provisions.[49] The report criticizes the Bureau's enforcement of the provision,[50] and is significant in two respects. First, none of the over seventy-five cases discussed involved the interplay between the imposition of the tax and a redemption transaction. Second, the report consistently analyzes each case in terms of the relationship between the amounts distributed and the corporation's current profits, concluding that the tax would be inapplicable if all the current profits were distributed.[51]

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dividend. In 1924, § 201(f) was enacted to reach situations where the redemption preceded the stock dividend. Revenue Act of 1924, ch. 234, § 201(f), 43 Stat. 253, 255. Finally, in 1926, § 201(g) amended § 201(f) of the 1924 Act to apply to any redemption "essentially equivalent" to a dividend whether or not connected with a stock dividend. *See* Herwitz, *supra* note 8, at 886-99; Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 14-15 (1956); Note, *Stock Redemption or Cancellation Taxable as Dividend*, 49 HARV. L. REV. 1344 (1936).

48. Revenue Act of 1926, ch. 27, § 220(e), 44 Stat. 9, 34-35. *See* S. REP. No. 52, 69th Cong., 1st Sess. 22, 1939-1 C.B. (Pt. 2) 332, 348-49.

49. JOINT COMM. ON INTERNAL REVENUE TAX'N, 69TH CONG. DIVISION OF INVESTIGATION PT. 3, REPORT ON EVASION OF SURTAXES BY INCORPORATION (SECTION 220) (Comm. Print 1927) [hereinafter cited as REPORT].

50. The *Report* noted that not one dollar had been collected from the provision from 1918 to the time of issuance of the REPORT. REPORT, *supra* note 49, at 33, 38.

51. See for example, the discussion of Company No. 101 where the Committee noted: "It is apparent from the above that the distribution of dividends in the year 1921 was nearly equal to the profit and that the application of section 220 to that year could not be sustained." REPORT, *supra* note 49, at 47. It should be noted that Company No. 101 had also fully distributed its net income in 1921, but that was not the focus of the analysis in this or in other cases. *Id.*

Indeed, congressional focus on the relationship between current profits and distributions as the trigger was apparent in a context diametrically opposite to that presented in *GPD*. *GPD* involves a corporation without current earnings and profits but with a large tax base. In the REPORT, the joint committee noted its concern with corporations which had large profits but no net income (tax base) on which the tax could be applied. This condition arose because domestic dividends were includible in profits but not in net income of a corporation. Revenue Act of 1921, ch. 136, §§ 232, 234(a)(6), 42 Stat. 227, 254-55. Even though there was no tax base, the unreasonable profits of such corporations were the object of congressional concern. In 1924, Congress provided that "net income" as used in § 220 included dividends received from domestic corporations. Revenue Act of 1924, ch. 234, § 220(d), 43 Stat. 253, 277. At least at this point in the legislative history, it seems apparent that Congress' concern was to ensure distribution of profits in a taxable year and that the tax base was just that—a base if adequate profits were not distributed. This suggests that if all the profits in a taxable year were distributed, the congressional objective would be satisfied even if net income remained. In fact, under the language of provisions prior to 1934, dividends did not reduce "net income." As a result, the Service would have been free to tax a corporation which had distributed all of its current profits on its "net income" if prior profits were accumulated un-

The Sixth Circuit in *GPD* placed great emphasis on a proposal rejected in the Revenue Act of 1928. The House attempted to substitute the words "to remain accumulated" for "to accumulate" in the provision.[52] However, the House Report asserted the proposed wording was "substantially the same" as prior law.[53] On the strength of the House Report and the Senate's silent rejection of the House's proposals, the Sixth Circuit concluded that Congress regarded both phrases as equivalent. There are other equally plausible inferences. For instance, even assuming the proposed substitute was identical to the existing wording, both phrases nonetheless refer only to *present* accumulations, not all accumulations past and present as the Sixth Circuit urged. Likewise, the phrase "gains and profits are permitted to remain accumulated" refers to profits of the current year that are not distributed, as does "permitting its gains and profits to accumulate." In view of the Senate's rejection of the House proposal and underlying explanation in the report, it is also possible to infer a congressional intent to penalize only current accumulations.[54]

Section 102 of the Revenue Act of 1934 allowed a corporation for the first time to deduct dividends paid to its shareholders.[55] This deduction was available to corporations that had paid some dividends during the taxable year even if they had unreasonably accumulated profits. Taxes were paid only on the net income the corporation actually retained.[56] For example, before the 1934 Act, if *X* Corporation earned $1,000,000 in the taxable year and distributed $800,000 in dividends *X* would have a tax base of $1,000,000 even though the accumulation was only $200,000. Under the 1934 Act's deduction for dividends, the base would equal those earnings not distributed, $200,000. Allowing a deduction for dividends further supports restricting the tax to undistributed current earnings. After 1934, once current earnings were distributed, there would be no remaining tax base even if prior earnings remained accumulated.

The deduction for dividends in the 1934 Act referred to any distribution out of earnings and profits.[57] A redemption constituted such a distribution to the extent it was not chargeable to the corporation's capital account.[58] More-

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reasonably. The Service never did and there is no suggestion in the committee report or elsewhere that it should have.

52. H.R. Rep. No. 1, 70th Cong., 1st Sess. 58-59 (Conf. Comm. Print 1927).

53. The report states: "Section 104(c) is substantially the same as section 220 of the 1926 Act . . . and provides that if any corporation . . . is formed or availed of to *permit its profits to remain accumulated,* in order to evade surtaxes, [the accumulated earnings tax] shall be imposed." H.R. Rep. No. 2, 70th Cong., 1st Sess. 17-18, 1939-1 C.B. (pt. 2) 384, 395-96 (emphasis added).

54. This was the conclusion reached by the Board of Tax Appeals in Corporate Inv. Co. v. Commissioner, 40 B.T.A. 1156, 1172 (1939), *non acq.*, 1940-1 C.B. 6. *See also* Comment, *supra* note 10, at 664-65.

55. Revenue Act of 1934, ch. 277, § 102(c), 48 Stat. 680, 702.

56. *See* H.R. Rep. No. 704, 73d Cong., 2d Sess. 11-12, 1939-1 C.B. (pt. 2) 554, 562-63. Actually, the tax base was equal to net income plus dividends received that were otherwise deductible from income at that time minus the dividends paid.

57. Revenue Act of 1934, ch. 277, § 115(a), 48 Stat. 680, 711.

58. *Id.* § 115(c) (partial liquidation includes redemption), (i) (partial liquidation of earnings and profits to extent not chargeable to capital account), 48 Stat. 680, 711-12.

over, the 1934 Act removed capital gains treatment for all liquidation transactions including redemptions.[59] Under the 1934 Act a redemption reduced the corporation's earnings and profits and the tax base of adjusted net income.[60] Consequently, it is difficult to imagine a situation where a corporation's prior earnings and profits could ever have triggered the tax.

As in previous Acts, the 1934 Act provided that the tax would not apply if all shareholders included their entire pro rata share, whether distributed or not, of the corporation's adjusted net income for such year in their own gross incomes.[61] This option reflects a congressional preference for pro rata shareholder inclusion. However, this shareholder election should not be read to prohibit corporations from avoiding the tax by fully distributing current earnings in a non-pro rata fashion. No such limitation appears in the statute.

The changes of the Revenue Act of 1936 substantially shaped the current provisions. For technical conformity with other Code provisions, the Act changed the term "gains and profits" to "earnings and profits."[62] More significantly, the 1936 Act introduced a new and untried taxing regime for corporations retaining income. Section 14(b) imposed a tax upon undistributed net income without regard to the purpose of its retention. This tax was designed to prevent corporations from accumulating income while shareholders avoided the applicable surtaxes.[63] The plan the House originally passed adopted this new tax structure, and eliminated the existing accumulated earnings tax.[64] As part of the House proposal, the deduction for dividends paid was transferred from section 102 to section 27.[65] Section 27 was to operate in the context of the proposed new tax. The Senate refused to drop the existing accumulated earnings provision, and kept section 102 in addition to the new tax.[66] The Senate version, which ultimately prevailed, amended section 102 to permit a deduction for dividends paid from the tax base as allowed in section 27.[67]

It is important that section 27 was not enacted with section 102 in mind. Congress never considered the impact of the dividends paid deduction con-

59. *Id.* § 115(c), 48 Stat. 680, 711. In 1936, favorable capital gains treatment was restored for distributions in complete liquidation. Revenue Act of 1936, ch. 690, § 115(c), 49 Stat. 1648, 1687-88. In 1942 partial liquidations (involving redemptions) became eligible for capital gains treatment. Revenue Act of 1942, ch. 619, § 147, 56 Stat. 798, 841.

60. *See* Revenue Act of 1936, ch. 690, § 27(f), 49 Stat. 1648, 1665 (which explicitly permits a deduction for distributions in liquidation which by virtue of § 115(c) & (i) include partial liquidation and redemptions).

61. Revenue Act of 1934, ch. 277, § 102(d), 48 Stat. 680, 702-03.

62. The change was not an attempt to alter existing law. *See supra* note 31.

63. *See* H.R. REP. No. 2475, 74th Cong., 2d Sess. 2-3, 1939-1 C.B. (pt. 2) 667, 668.

64. *Id.* at 9, 1939-1 C.B. at 674. Actually, the House proposed that § 102, the accumulated earnings tax provision, be revised to apply only to banks, insurance companies, foreign corporations, China Trade Act corporations, certain domestic corporations doing business in the possessions of the United States and personal holding companies. *Id.* 1939-1 C.B. at 674.

65. Under Revenue Act of 1936, ch. 690, § 27(g), 49 Stat. 1648, 1665, preferential dividends did not qualify for the dividends paid deduction.

66. S. REP. No. 2156, 74th Cong., 2d Sess. 16-17, 1939-1 C.B. (pt. 2) 678, 688.

67. Revenue Act of 1936, ch. 690, § 102(c)(2), 49 Stat. 1648, 1677.

tained in section 27 upon section 102.[68] That preferential dividends could reduce earnings and profits but not the tax base under section 102 never occurred to Congress. Moreover, there is nothing in the 1936 Act that remotely suggests once current earnings and profits were distributed, prior earnings could trigger a tax on any remaining tax base.[69] The House Report on the new tax clearly states: "No attempt is made under the bill to tax past accumulations of surplus."[70] In sum, the prohibition against deducting preferential dividends in computing the accumulated earnings tax under the 1936 Act does not support the conclusion that the tax can be triggered if all current earnings are distributed.

The confusion and hardship that the new tax on undistributed profits generated in the 1936 Act led to its eventual abandonment[71] in the Revenue Act of 1938.[72] The 1938 Act also adopted the predecessor of the consent dividend provision in current section 565.[73] In neither the 1938 Act nor the subsequent acts culminating with the Revenue Act of 1954 is there any indication that Congress intended to assess any additional tax on a corporation which distributed all its current earnings and profits in fact or by consent, even though the corporation may have had a taxable base on which an accumulated earnings tax could have been applied.[74]

When the history of the accumulated earnings tax is examined from its inception in 1913, there is absolutely no indication that Congress seriously considered whether current earnings and profits were a prerequisite for imposition of the tax. Indeed, the question at hand is perhaps an illustration of the tax

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68. Section 27 is the predecessor of § 562 (1976) while § 102 is the forerunner of § 532 (1976). *See supra* notes 65 & 67.

69. See discussion *infra* text accompanying notes 108-26, in which this paper takes the position that a redemption at fair market value is in fact nonpreferential. There is no question that a nonpreferential redemption qualified for the dividends paid deduction under the 1936 Act. *See* Revenue Act of 1936, ch. 690, §§ 27(f), 115(c) & (i), 49 Stat. 1648, 1665, 1687-89.

70. H.R. REP. No. 2475, 74th Cong., 2d Sess. 3-4, 1939-1 C.B. (pt. 2) 667, 669.

71. *See* S. REP. No. 1567, 75th Cong., 3d Sess. 2-5, 1939-1 C.B. (pt. 2) 779, 780-82; Revenue Act of 1938, ch. 289, § 14, 52 Stat. 447, 456-57.

72. *See* CONF. REP., H.R. REP. No. 2330, 75th Cong., 3d Sess. 32-33, 1939-1 C.B. (pt. 2) 817-18. The surtax on undistributed profits was phased out by the end of 1939.

73. *See* H.R. REP. No. 1860, 75th Cong., 3d Sess. 24, 1939-1 C.B. (pt. 2) 728, 745. In general terms, section 28 under the 1938 Act, like the current section 565, permits a corporation to include as part of the dividends paid deduction, any undistributed net income as though the amount had actually been distributed. Revenue Act of 1938, ch. 289, § 28, 52 Stat. 447, 470-72. Under current law, I.R.C. § 535(a) defines "accumulated taxable income," the tax base, to include a deduction for dividends paid as defined in § 561 which incorporates qualifying consent dividends under § 565.

The Revenue Act of 1938 also toughened the taxpayer's burden of justifying any accumulations by shifting the burden of proof to him. Revenue Act of 1938, ch. 289, § 102, 52 Stat. 447, 483; United States v. Donruss Co., 393 U.S. 297, 306 (1969).

74. The committee reports accompanying the Revenue Act of 1954 do not suggest any change in the meaning of the phrase "permitting earnings and profits to accumulate instead of being divided or distributed." *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 51-54, A172-74, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4077-80, 4311-13; S. REP. No. 1622, 83d Cong., 2d Sess. 68-72, 314-18, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4700-04, 4954-58.

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lawyer's apocryphal rule of statutory interpretation: if the legislative history is not clear on its face, turn to the wording of the statute.

The Statutory Provisions

After drawing conclusions from the largely inconclusive legislative history, the Sixth Circuit in *GPD* turned to the statute itself and offered additional reasons why section 532 triggers a tax in the absence of an accumulation of earnings and profits in the current year. The court noted the unassailable fact that prior accumulations are relevant in determining whether current accumulations are reasonable.[75] Use of prior accumulations as an evidentiary matter, however, does not mean that prior accumulations automatically act to trigger corporate liability.[76] Acts committed during a period the statute of limitations has closed may be relevant evidence in determining some aspect of a current matter, but those acts should not give rise to liability.[77]

Citing the wording of section 535(c)(1), the accumulated earnings credit, the Sixth Circuit concluded that Congress knows how to write a clear provision that pertains only to current earnings and profits. Section 535(c)(1) allows an accumulated earnings credit against accumulated taxable income for "an amount equal to such part of the earnings and profits *for the taxable year* as are retained for the reasonable needs of the business."[78] The court concluded that the triggering accumulations in section 532 refer to accumulations from any year; yet the language of section 535(c) points in the opposite direction. If any prior accumulation could trigger the tax, Congress would have allowed an earnings credit, which was not limited by current earnings, for prior earnings retained for the reasonable business needs. Congress was concerned, however, only with current earnings that were unreasonably accumulated. Hence, in enacting section 535(c) the Senate commented: "Your committee has . . . provided a credit for the profits of the taxable year which are retained for the reasonable needs of the business. . . . This in effect provides two changes in present law. *In the future this tax will apply only to the amount unreasonably accumulated.*"[79] The Senate's conclusion only makes sense if the reference is to current earnings, because the credit applies only to the current year's earnings and profits.

In analyzing the accumulated earnings tax provisions, the Sixth Circuit in

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75. 508 F.2d at 1087. *See* S. REP. No. 1622, *supra* note 74, at 317, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS at 4957.

76. 508 F.2d at 1087.

77. *See* Commissioner v. Disston, 325 U.S. 442, 449 (1955) (an adjustment in a net gift figure for an earlier year closed by the statute of limitations can be used in determining gift tax liability in an open year without subjecting the taxpayer to assessment and collection for the closed year). *See also* Arthur W. Clark v. Commissioner, 65 T.C. 126 (1977); Fred A. Berzon v. Commissioner, 63 T.C. 601, 620 (1975). In an analogous area Federal Rule of Evidence § 404(b) expresses the same concept. *See, e.g.,* United States v. Rocha, 553 F.2d 615 (9th Cir. 1977).

78. I.R.C. § 535(c)(1) (1976) (emphasis added).

79. S. REP. No. 1622, *supra* note 74, at 72, *reprinted in* U.S. CODE CONG. & AD. NEWS at 4704 (emphasis added). The minimum credit after 1981 is $250,000. *See supra* note 4.

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GPD also relied on two points raised in *Ostendorf-Morris Co. v. United States*,[80] an unreported district court case involving the same issue. In *Ostendorf-Morris*, the district court hypothesized a situation where in year one, a corporation, in accordance with the reasonable business needs, accumulates earnings of $500,000 for a redemption in year two.[81] If in year two the corporation has current earnings of $500,000 and the redemption takes place, there may be no current earnings to trigger a tax. According to the court, the result is a double credit for earnings and profits used for the redemption.[82] The same possibility for a double credit exists in any situation where a corporation accumulates for a legitimate corporate purpose and subsequently does not use the prior accumulated funds for that purpose.[83] The solution to this problem is for the Service to go back and assess a tax for the earlier year if it is still open under the statute of limitations. If there is a danger the year might close, the Service should secure an agreement that the year remain open.[84]

The *Ostendorf-Morris* court supported its conclusion by pointing out the absurd result when one cent of current earnings and profits not distributed in the current year in a redemption transaction might trigger a tax on a large tax base the redemption fails to diminish.[85] The response to this suggestion is twofold. First, because a small accumulation of earnings and profits can be justified as necessary for the reasonable business needs it should not trigger the tax. Alternatively, section 565 allows shareholders to elect to treat the amount as a dividend by filing a consent with the corporation's tax return. These consent dividends will decrease earnings and profits.[86] Thus, the corporation that fails to distribute all of its current earnings and profits in a redemption can have its shareholders file a consent for the remaining earnings, thereby avoiding the liability on the large tax base that the redemption fails to reduce.

The Relationship Between a Redemption and Accumulated Taxable Income

In *GPD*, the taxpayer conceded that the redemption did not reduce its accumulated taxable income.[87] This concession was probably prompted by section

80. 26 A.F.T.D.2d (P-H) ¶ 70,5369 (N.D. Ohio 1968).
81. *Id.* at ¶ 70-5372.
82. *Id.* at ¶ 70-5372 to -5373.
83. *E.g.*, X Corporation accumulates $500,000 in year one for expected increased operating expenses in year two. In year two, X earns an unexpected $500,000 which it uses to pay the operating expenses, reducing the adjusted taxable income to zero.
84. *See, e.g.*, I.R.C. § 1034 (West 1981), Treas. Reg. § 1.1034-1(i) (1960). A question related to the treatment of pre-redemption accumulations is the treatment of post-redemption accumulations when the taxpayer redeems with notes. *See* Rudolph, *supra* note 7, at 118-20; Herwitz, *supra* note 13, at 900-04.
85. 26 A.F.T.R.2d (P-H) at 5372.
86. Treas. Reg. § 1.565-3(a), T.D. 6777, 1965-1 C.B. 8, 12. *See also* I.R.C. § 563 (1976) permitting a distribution of the remaining earnings and profits after the close of the taxable year to qualify as a distribution paid during the taxable year.
87. 508 F.2d at 1080. The taxpayer in *Ostendorf-Morris* made the same concession. 26 A.F.T.R.2d (P-H) at 5372.

562(c), which provides that only distributions made on a pro rata basis, without preference, shall qualify for the dividends paid deduction.[88] The Service and the courts generally consider that a redemption of the shares of one shareholder is both non-pro rata and preferential because nonredeeming shareholders receive nothing from the corporation.[89]

As a matter of pure statutory interpretation it seems imprudent to apply section 562(c) to redemptions. When read in conjunction with section 346(a), section 562(b) clearly envisions a redemption as qualifying for the dividends paid deduction. Indeed, section 346(a) unequivocally states: "For purposes of section 562(b) . . . a partial liquidation includes a redemption of stock to which section 302 applies."[90] If section 562(c) is applicable to redemptions, no redemption could qualify for the dividends paid deduction because such distributions *must* be non-pro rata. Congress would not have singled out redemptions for inclusion in section 562(b) only to completely eliminate them in section 562(c).

Neither the Congress nor the courts have focused on why preferential distributions should not qualify for the dividends paid deduction.[91] Presumably, the limitation was aimed at preventing corporations from eluding a corporate level tax on undistributed earnings by distributing those earnings to selected shareholders in low tax brackets.[92] This goal is suspect. The purpose of an accumulated earnings tax is to prod a corporation into fully distributing or gainfully employing its earnings rather than sheltering them from individual tax rates.[93] If a corporation distributes its earnings to its shareholders, the form of that distribution should be irrelevant. Disqualifying a redemption from the dividends paid deduction undercuts section 302 which entitles a qualifying redemption to capital gains treatment. Section 532 is concerned with shareholders avoiding individual income tax, not avoiding corporate dividend treatment. The rate a shareholder is taxed on a distribution is irrelevant when considering whether the dividends paid deduction is available. Section 562(b) qualifies some capital gains transactions for the dividends paid deduction.[94] Moreover, even if the recipient escapes tax altogether, the deduction may be available.

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88. I.R.C. § 562(c) (1976) provides:

> (c) Preferential Dividends—The amount of any distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction, unless such distribution is pro rata, with no preference to any share of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference.

89. See *infra* text accompanying notes 97-104. There is no indication that the terms "preferential" and "non-pro rata" are intended to set up two distinct tests.

90. I.R.C. § 346(a) (1976).

91. *See* Paul, *The Federal Corporate Surplus Tax,* 23 CORNELL L.Q. 72, 82-83 (1937) (arguing against the preferential dividend limitation).

92. *See, e.g.,* Black Motor Co. v. Commissioner, 125 F.2d 977, 979 (6th Cir. 1942) (compelling distribution to shareholders in order to collect the tax on corporate surpluses).

93. *See* United States v. Donruss Co., 393 U.S. 297, 303 (1969); Helvering v. Chicago Stock Yards Co., 318 U.S. 693, 699 (1943).

94. *See, e.g.,* Deviney Constr. Co. v. Commissioner, 1976 T.C.M. (P-H) ¶ 76,386.

The Revenue Act of 1936 provides that the dividend recipient's tax status does not affect the dividend credit accorded the distributing corporation.[95] If state and federal law regulating corporate behavior, along with a corporation's own bylaws and contractual obligations, permit the making of preferential distributions under specified circumstances, the Code should not interfere by penalizing sanctioned activities.[96] A preferential distribution is not a sham. The corporation makes a distribution of its earnings and profits and the recipient shareholders have income to report. In the case of a redemption, the redeeming shareholder, in order to qualify under section 302, has to significantly decrease his equity interest in the corporation.

REDEMPTIONS AS NONPREFERENTIAL DISTRIBUTIONS

The language of section 565(c) remains an obstacle to a dividends paid deduction for preferential distributions. However, if it can be shown that a redemption involving less than all of the shareholders is pro rata and nonpreferential, then whether current earnings and profits are necessary as a triggering mechanism becomes irrelevant. By reducing accumulated taxable income, a redemption might eliminate the tax base even if prior earnings and profits trigger a tax.

In *H. H. King Flour Mills Co. v. United States*,[97] one of two fifty percent shareholders in the plaintiff corporation surrendered his shares of stock in redemption for half of the corporation's assets.[98] Although the corporation had been liable for the accumulated earnings tax in prior years the taxpayer contended that the tax was inapplicable to the year of redemption. Claiming a dividends paid deduction under section 561 for the portion of the redemption proceeds not chargeable to the corporation's capital account, the corporation eliminated its accumulated taxable income.

The thrust of the corporation's argument was that section 562(c) required only that the redemption be in proportion to the distributee's ownership interest in order to be pro rata and nonpreferential.[99] The court rejected this "novel theory" and followed the uniform interpretation that pro rata distribution must reflect the different proportional interest of the shareholders.[100]

95. H.R. REP. No. 2475, 74th Cong., 2d Sess 11 (1936). *See* Helvering v. Credit Alliance Corp., 122 F.2d 361 (4th Cir. 1941), *aff'd*, 316 U.S. 107 (1942) (dividends paid deduction allowed for nontaxable liquidating distribution).

96. As stated by Judge Learned Hand:

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everyone does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting), *cited with approval in* Atlantic Coast Line v. Phillips, 332 U.S. 168, 173 (1947).

97. 325 F. Supp. 1085 (D. Minn. 1971).

98. The shareholders had executed an agreement which provided that either party could have his stock redeemed by the corporation upon his request. *Id.* at 1086.

99. *Id.* at 1087.

100. *Id.* (footnote omitted).

Unfortunately, the court in *H. H. King* is in the mainstream of the case law. Typical earlier cases are *May Hosiery Mills, Inc. v. Commissioner*[101] and *Forstner Chain Corp. v. Commissioner*.[102] In *May Hosiery* the taxpayer purchased a portion of the shareholders' preferred stock on the open market and claimed a dividends paid credit under the predecessor of section 562(b).[103] After concluding that the preferential limitation applies to redemptions as well as dividends, the court determined that the corporate purchases were preferential since not all holders of the preferred stock surrendered their shares.[104]

In *Forstner Chain* the taxpayer offered to purchase from its three shareholders a specified number of preferred shares. Two of the shareholders waived their rights while the third accepted. The court rejected the argument that the distribution was not preferential due to the waiver by the nonredeeming shareholders.[105] In a recent private letter ruling, the Service continued to deny the deduction without analysis.[106] When a redemption is analyzed it becomes clear that it may be a nonpreferential, pro rata distribution. To illustrate: *X* Corporation, with 120 shares outstanding, has two shareholders, *A* and *B*, who each owns sixty shares with a fair market value of thirty dollars per share. *X* Corporation, which was started when *A* and *B* each contributed $1,200 in capital, has $1,200 earnings and profits in cash.[107] *B* needs $1,200 for personal reasons and is willing to reduce his fifty percent interest in *X* to twenty-five percent. If *X* Corporation were to redeem forty shares of *B*'s stock for $1,200, the Service would take the position that no portion of the redemption qualifies for the dividends paid deduction because only *B* received cash. However, if *B* received a $1,200 cash dividend while *A* received 120 shares of additional *X* stock with a fair market value of $1,200,[108] X would be entitled to a dividends paid deduction which would decrease its adjusted taxable income. Both distribution patterns end in identical economic positions: *B* with $1,200 in cash, twenty-five percent of *X* Corporation and stock worth $600 and *A* with seventy-five percent of *X* stock worth $1,800.[109] If one pattern justifies a dividends paid deduction, there is no reason why the other should not.

Consider the nonredeeming shareholders' position in a clearly preferential distribution. Suppose *X* Corporation had merely distributed $1,200 as a divi-

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101. 42 B.T.A. 646 (1940), *aff'd*, 123 F.2d 858 (4th Cir. 1941).

102. 45 B.T.A. 19 (1941). *See also* Safety Convoy Co. v. Thomas, 139 F.2d 219 (5th Cir. 1943); George E. Warren Co. v. United States, 53 F. Supp. 578 (D. Mass. 1944); I.T. 3244, 1939-1 C.B. 181, 182.

103. Revenue Act of 1936, ch. 690, § 14(a)(2), 49 Stat. 1648, 1656 (1936).

104. 123 F.2d at 861.

105. 45 B.T.A. at 21.

106. Letter Ruling 8033031. *See also* Letter Ruling 6305035884.

107. This illustration will ignore any application of the accumulated earnings credit provided by § 535(c).

108. Following the distribution, there would be 240 shares of stock participating in the $2,400 of *X* Corporation assets.

109. After the redemption, *A* owns 60 out of 80 shares or 75% of the outstanding shares. Following the stock and cash distribution, *A* would still own 75%, represented by 180 out of 240 shares. In both patterns *X* Corporation after having distributed $1,200 in cash has a fair market value of $2,400.

dend to *B*. The distribution would have decreased the value of *X* from $3,600 to $2,400 and accordingly the fair market value of the stock held by *A* and *B* from $1,800 to $1,200 each. Consequently, *B* would hold $1,200 in stock and $1,200 in cash after the distribution while *A* would only hold $1,200 in stock. Under these facts *B* has increased his involvement from $1,800 of stock originally to $2,400 in stock and cash while *A*'s holdings decreased from $1,800 to $1,200.

If this were a redemption and *B* surrenders forty shares upon receiving $1,200 from *X* Corporation, *A* receives the equivalent of a stock dividend. Instead of holding stock with a fair market value of $1,200, *A*'s stock increases in value to $1,800.[110] Upon surrendering forty shares of stock, *B* decreases his stock ownership from sixty to twenty shares or from $1,200 to $600. *B* has received $1,200 of cash from *X* Corporation but only by transferring $600 in stock to *A*. When the smoke clears, *A* and *B* continue to be in the same relative positions: *B* holds twenty shares of *X* stock worth $600 and $1,200 in cash, a total of $1,800, the value of his original holding in *X* while *A* continues to own *X* stock with a fair market value of $1,800. The redemption does not treat either shareholder preferentially.

The House Report on the Revenue Act of 1938[111] indicated that distributing stock to some shareholders while distributing cash to others qualifies for a dividends paid deduction.[112] Similarly, in *Southeastern Finance Co. v. Commissioner*,[113] the Tax Court recognized that a distribution in which some shareholders get stock and others get cash in a pro rata amount is not preferential.[114] Both the House Report and *Southeastern Finance* discussed situations where the shareholders had the option of choosing cash or stock. In a redemption situation, the nonredeeming shareholders have no option to receive cash; instead they constructively receive stock inasmuch as their percentage of stock ownership increases.[115] Yet the fact that the nonredeeming shareholders receive

110. Following the redemption there are 80 shares outstanding participating in *X*'s assets of $2,400 or $30 per share. *A* owns 60 shares.

111. H.R. REP. No. 1860, 75th Cong., 3d Sess. 1, 1939-1 C.B. (pt. 2) 728.

112. In discussing how minor variations in the value of distributions will not taint a distribution as preferential, the Report cites the following example:

> To illustrate: Suppose the case in which a stock dividend distribution is coupled with an option equally available to all the shareholders to take cash or stock, and in which $100 in cash is paid to one shareholder, while there is issued to another shareholder one share of stock which happens to have, on the date on which the distribution was authorized, or on the date of its receipt by the shareholder, an exchange value of $99.75. An impartial distribution of this character should not be considered to be preferential. Such has been the Treasury's construction of the existing law.

Id. at 23, 1939-1 C.B. at 744.

113. 4 T.C. 1069 (1945).

114. *Id.* at 1090-91. *See also* Union Sugar Co. v. Commission, 1 T.C.M. (CCH) 159 (1942).

115. In many closely held corporations, a decision to distribute earnings and profits in a redemption to avoid the accumulated earnings tax probably could be made available to all shareholders without foreclosing the transaction. If the option is open, the redemption is tantamount to an election under I.R.C. § 305(b)(1) (1976) and fits squarely within the language of the legislative history.

one form of property while the redeeming shareholders receive another should be irrelevant if the fair market values are the same. Assuming accurate valuation, a rational shareholder should be indifferent to receiving $100 in stock or $100 in cash.[116]

While both the House Report and *Southeastern Finance* discussed dividend distribution characterized under the predecessor to section 305(b)(1), there is no reason to presume that a distribution under section 305(b)(2) would run afoul of the preferential restrictions of section 562(c), assuming shareholders received pro rata distributions as measured using the value of what they received. Because a distribution under section 305(b)(2) is economically equivalent to a redemption, a redemption of stock at fair market value must also be adjudged nonpreferential.

The House Report on the Revenue Act of 1938 supports the interpretation that a preferential distribution is one that diverts corporate assets away from some shareholders to other shareholders rather than one that preserves a balance among shareholders.[117] A redemption at fair market value is ordinarily completely consistent with the rights of all shareholders. An individual purchasing stock may be protected against preferential distributions,[118] but no corporation will ensure that it will not purchase the shares of other stockholders at fair market values or that, if it does, other shareholders have the right to redeem.[119] Indeed, there is no need for such assurances because a fair

116. This conclusion ignores transaction costs which may make stock ownership slightly less desirable. However, in general the costs incurred on the sale of stock are not great. Moreover, the costs offset the selling price thereby reducing gain recognized on the sale or creating a loss deduction. Treas. Reg. § 1.263(a)-2(e), T.D. 6794, 1965-1 C.B. 128, 133-34. In addition to transaction costs, the stock's transferability may be restricted, but any restriction should be reflected in the value of the stock received because expected earnings would be discounted at a higher rate due to the illiquidity.

117. H.R. REP. No. 1860, 75th Cong., 3d Sess. 23, 1939-1 C.B. (pt. 2) 728, states in part that:

> Subsection (h) of the bill, relating to "preferential dividends" has the same purpose as section 27(g) of the existing law . . . . No dividends-paid credit should be allowed in the case of a distribution not in conformity with the rights of shareholders generally inherent in their stockholdings, whether the preferential distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance . . . . The committee believes that no distribution which treats shareholders with substantial impartiality and in a manner consistent with their rights under their stockholding interest, should be regarded as preferential by reason of minor differences in valuations of property distributed.

Id. at 744.

118. *See, e.g.,* Wilderman v. Wilderman, 315 A.2d 610 (Del. Ch. 1974), where the court ordered repayment of excessive compensation taxed as dividend distribution. For examples of judicial relief from preferential distributions, see Chicago Stadium Corp. v. Scallen, 530 F.2d 204 (8th Cir. 1976) (control shareholders issued themselves treasury shares); Corbin v. Corbin, 429 F. Supp. 276 (M.D. Ga. 1977) (diversion of cash and auto for personal use); Miller v. Magline, 76 Mich. App. 284, 256 N.W.2d 761 (1977) (control shareholder withheld dividends while paying himself high salary).

119. *See* MODEL BUSINESS CORP. ACT (MBCA) § 6 (empowering a corporation to acquire its own shares), § 15 (authorizing corporations to issue corporate shares "with such designations, preferences, limitations, and relative rights as shall be stated in the articles of in-

market value redemption has no unfair effects on the holdings of the non-redeemers.

A distribution is preferential when corporate assets are diverted from some shareholders to others. In the example above, if *X* Corporation distributed a $1,200 dividend to *B*, *A* and *B* would each hold sixty shares of stock valued at $1,200 instead of $1,800. Thus, while *A* would hold $1,200 of value as a result of his corporate association, *B* would hold $2,400. These facts show a preferential distribution to *B* under section 562(c). Arguably, because only $600 of the distribution represents a diversion from *A*, the other $600 is non-preferential and therefore should not be precluded from the dividends paid deduction. However, courts have uniformly ruled that the entire distribution fails to qualify.[120]

The predecessor to section 562(c) was enacted to quiet congressional fears that corporations would escape taxation on accumulated earnings by funneling a distribution to a shareholder in a low individual tax bracket.[121] While congressional fears might be realized where preferential dividends are used, qualifying redemptions offer no such concern. When a corporation makes a qualifying redemption it receives stock from the redeeming shareholder, who must relinquish a degree of his equity in the corporation upon receiving the distribution. There is no sham involved: the corporation cannot hide assets because it has been enriched in an amount equal to the redeemed stock.

While the case law for the most part does not favor distinguishing between preferential dividends and nonpreferential redemptions, there are exceptions. In both *National Securities Series v. Commissioner*[122] and *New York Stocks v. Commissioner*,[123] courts allowed corporations to deduct redemption proceeds

corporation") (1979). As stated in Donahue v. Rodd Electrotype Co. of New England, Inc., 367 Mass. 578, 598 n.24, 328 N.E.2d 505, 518 n.24 (1975):

> Of course, a close corporation may purchase shares from one stockholder without offering the others an equal opportunity if all other stockholders give advance consent to the stock purchase arrangements through acceptance of an appropriate provision in the articles of organization, the corporate by-laws . . . , or a stockholder's agreement . . . . Similarly, all other stockholders may ratify the purchase.

Id., 328 N.E.2d at 518 n.24 (citations omitted). Under the particular facts of *Donahue*, the court held that the corporation was bound to offer every shareholder an equal opportunity to sell his shares back to the corporation. *Id.* at 602, 328 N.E.2d at 519. In *Donahue* the shares owned by the elderly father of the controlling shareholders were purchased for $800 per share when within the previous four years the corporation had offered to purchase shares owned by minority shareholders at prices ranging from $40 to $200 per share. *Id.* at 583, 328 N.E.2d at 510. *See also* Brown v. Little, Brown & Co., 269 Mass. 102, 168 N.E. 521 (1929).

120. *See, e.g.*, Black Motor Co. v. Commissioner, 125 F.2d 977 (6th Cir. 1942). In *Black*, dividend payments were not made in proportion to stock ownership. The two principal shareholders received 100% of their pro rata portion while sixteen other shareholders received only 50% of their respective shares and one received only 25%. *Id.* at 979. The court denied any dividends paid credit for the entire distribution, not just that portion of the distribution which was a diversion from the nonreceiving shareholders.

121. *See supra* notes 62-70 and accompanying text.

122. 13 T.C. 884 (1949).

123. 164 F.2d 75 (2d Cir. 1947). *See also* Letter Rulings 6305035880A & 5410056230A following *National Securities Series* and *New York Stocks.*

in calculating the dividends paid credit. However, these cases involved open-end regulated investment companies and have been distinguished in subsequent decisions on that basis.[124]

The taxpayer in *New York Stocks* was required to distribute at least ninety percent of its current income in exchange for a privileged tax status. Investors were entitled to surrender their shares at any time in exchange for their proportionate share of earnings, profits and assets. The court allowed a dividends paid deduction on each redemption because it would have been impossible to make balancing payments to all the nonredeeming shareholders. Emphasizing the availability of the redemption procedure to all taxpayers on an impartial basis, the court reasoned the distribution was fair because redeeming shareholders got their proportionate share of earnings at redemption and nonredeeming shareholders would be paid at the end of dividend period.[125]

The thrust of the court's argument is correct, but whether or not the nonredeeming shareholders receive dividends is irrelevant. Even if their proportionate share of earnings are not distributed, the nonredeeming shareholders will enjoy appreciation in the value of their stock. Any liquidity problems to realizing that appreciation should have been reflected in the original price of the stock to the shareholder. Thus, if shareholder *A* invests $500 in *X* Corporation stock and *A*'s ability to sell or redeem, is restricted, *A* might insist upon receiving $700 face value of restricted stock as compensation for lost liquidity. If *B* had purchased $500 of unrestricted stock that gave him the right to have his holdings redeemed and he does so, *A* is not treated disadvantageously. *A*'s stock appreciates by his proportional share of the earnings, and his $700 holding compensates him for any lack of liquidity.

Under similar facts, the Tax Court in *National Securities* followed *New York Stocks* and concluded:

> Where a distribution is made available in conformity with the rights of each stockholder, where no act of injustice to any stockholder is contemplated or perpetrated, where there is no suggestion of a tax avoidance scheme, and where each stockholder is treated with absolute impartiality, the distribution is not preferential within the meaning of the statute.[126]

Assuming that a redemption is in conformity with a corporation's legal obligations to its shareholders, the thrust of the court's statement is equally applicable where a shareholder's decision not to have his shares redeemable at

124. *See, e.g., H.H. King*, 325 F. Supp. 1088 n.2.

125. 164 F.2d at 79. The court stated that: "More important is the fact that every shareholder receives his fair proportion of the earnings during the period he elects to remain an owner, those redeeming being paid when they redeem, those retaining ownership being paid at the end of petitioner's dividend period." *Id.*

126. 13 T.C. at 888, *quoting* United Artists Theatre Circuit, Inc. v. Commissioner, 1 T.C. 424, 430 (1943). Where the court held that a recapitalization in which some shareholders received cash while others elected to postpone their exchange would not be treated as preferential since all shareholders could eventually receive their pro rata share. *See also* Union Sugar Co. v. Commissioner, 1 T.C.M. (CCH) 159 (1942) (redemption of preferred shareholders in exchange for cash or common stock was not preferential).

will is made when the stock is purchased as when the decision is later made by not exercising an option to redeem.

Conclusion

The problem of applying the dividends paid credit to redemptions arises only because the accumulated earnings tax provisions employ a different concept for the triggering and base measure. The best resolution of the problem would be to use the same measures to trigger the tax and to complete the tax. If the tax is designed to limit corporate ability to retain earnings and profits, then Congress should base the tax on current retentions without regard to the character of distributions. Even given the dichotomy of the triggering and base measures, however, a redemption at fair market value that would be necessarily nonpreferential, which distributes all of a corporation's earnings and profits for the year or years in issue, should still relieve the corporation of accumulated earnings tax liability regardless of the reason for the redemption.