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Taxation—Calculation of Corporate Earnings and Profits—Cash Basis Association —Accrual of Federal Taxes Due in Determining Earnings and Profits.—Demmon v. United States

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> [T]he fact that the system . . . was used in both intrastate and interstate commerce did not derogate from the application of Section 605 to the particular telephones or telephone lines referred to in the indictment.[22]

Turning to the wording of section 10(b) itself it is clear that the transaction need not be interstate just as long as some "means or instrumentality of interstate comerce"[23] is in some way involved. It is also significant that when Congress wrote the comparable Section 17(a) of the Securities Act of 1933[24] the wording used was "use of any means or instruments . . . *in* interstate commerce."(Emphasis added.) This language seems to direct the kind of "use" test that the *Rosen* court proposes. But in section 10(b) Congress has changed this wording to "use of any means or instrumentality *of* interstate commerce."[25] (Emphasis added.) This would indicate that Congress was shifting its aim from the incidental use to the instrument itself. In this light the telephone is indisputably an instrument "of interstate commerce." These several factors indicate that when future courts reach this cross-road they will undoubtedly be inclined in the direction of the *Nemitz* decision.

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Taxation—Calculation of Corporate Earnings and Profits—Cash Basis Association—Accrual of Federal Taxes Due in Determining Earnings and Profits.—*Demmon v. United States*.[1]—The plaintiffs received and paid taxes on a trust distribution and now seek to recover a refund. The Tax Court had determined that the distributing body, Land Trust, which had computed and paid its taxes at trust rates, was an association taxable at corporate rates.[2] The court disallowed its distribution deduction and asserted a substantial additional tax for the years in question.[3] In any one of the years under examination, the amount of cash available for distribution out of earnings and profits would have been less than the amount actually distributed if the additional federal taxes due on current earnings had been deducted. The plaintiffs' yearly distribution from the trust was thus made up of not only earnings and profits of that tax year, but also of payments from some other fund-source of Land Trust (a distributing body which the government was now treating as a corporation for tax purposes). Their theory for a refund was that the difference between the amount distributed each

[22] Id. at 55-56.
[23] Supra note 3.
[24] Securities Act of 1933 § 17(a), 48 Stat. 74 (1933), 15 U.S.C. § 77q(a) (1958).
[25] Supra note 3.

[1] 321 F.2d 203 (7th Cir. 1963).
[2] Estate of Scofield v. Commissioner, 25 T.C. 774 (1956), affirmed on this issue, 266 F.2d 154 (6th Cir. 1959).
[3] The substantial additional tax totaled $500,000 for the years 1945 to 1955.

year and the amount that would have been available for distribution from earnings and profits, computed by deducting the additional federal tax due, would be a return of capital and non-taxable. The district court dismissed the plaintiffs' suit; court of appeals reversed. HELD: the plaintiffs, who received and paid taxes on the trust distribution, are entitled to a refund to the extent the cash distribution did not come from earnings and profits, in that a "cash basis accounting" corporation is allowed to accrue federal taxes due but not yet paid in computing earnings and profits.[4]

The question as to whether a corporation which uses the cash receipts and disbursements method of accounting in computing its income subject to tax, may then accrue federal income taxes in computing earnings and profits has received varied judicial answers.[5] In *Helvering v. Alworth Trust*,[6] the court held that a cash receipts basis corporation in determining earnings and profits for the year 1937 could not subtract the federal income tax due for that year where the tax had not been paid. The corporate taxpayer could deduct the federal tax paid in 1937 on the 1936 earnings.

An opposite result was reached in *Drybrough v. Commissioner*.[7] In the latter case a deficiency had been determined against a cash basis corporation on unreported income, which, it was discovered, had been embezzled by its controlling stockholders. The Sixth Circuit agreed with the stockholders that in determining what portion of the embezzled fund constituted a constructive dividend, the corporation could deduct the corporate tax deficiency in computing earning and profits. Where, in other cases, the instant issue has been examined, the result reached was determined by relying on either *Drybrough* or *Alworth*.[8]

The courts which have allowed the accrual of federal taxes, including the instant court, have yet to fully articulate the rationale for this position, though indeed, one may be found. The 1954 Internal Revenue Code and its predecessors have defined a dividend in terms of distributions of property made by a corporation to its shareholders from earnings and profits.[9] To the extent that a distribution is not a dividend it is treated first as a non-

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[4] E.g., Schwanbeck, The Accountant's Problem in Working with "Earnings and Profits" for Tax Purposes, 10 J. Taxation 22 (1959); Albrecht, "Dividends" and "Earnings or Profits," 7 Tax L. Rev. 157 (1952); Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law: Corporate Non-Liquidating Distributions, 89 U. Pa. L. Rev. 865 (1941); Emmanuel, Earnings and Profits: An Accounting Concept?, 4 Tax L. Rev. 494 (1949).

[5] Answering in the negative: Helvering v. Alworth Trust, 136 F.2d 812 (8th Cir. 1943); Newark Amusement Corp. v. Commissioner, 1960 CCH T.C. Mem. 705, 715; Dean v. Commissioner, 9 T.C. 256 (1947). Answering in the affirmative: Simon v. Commissioner, 248 F.2d 869 (8th Cir. 1957); Drybrough v. Commissioner, 238 F.2d 735 (6th Cir. 1956); Hadden v. Commissioner, 49 F.2d 709 (3d Cir. 1931); Thompson v. United States, 214 F. Supp. 97 (N.D. Ohio 1962); Bender v. Commissioner, 1957 CCH T.C. Mem. 502, 518.

[6] Helvering v. Alworth Trust, supra note 5.

[7] Drybrough v. Commissioner, supra note 5.

[8] Supra note 5.

[9] Int. Rev. Code of 1954 § 316(a).

taxable return of capital.[10] To the extent the distribution exceeds the basis, it is treated as a gain from the sale or exchange of property.[11]

Because the Code defines a dividend in terms of earnings and profits, whether a distribution can qualify as a dividend depends on its being a distribution from earnings and profits. It is the plaintiffs' contention that by accruing the additional federal income taxes due in computing earnings and profits in any of the years in question, the amount of cash available to qualify as a dividend was reduced and this amount should be treated as a non-taxable return of capital. The merit of the plaintiffs' contention depends on an understanding of the similarities and differences between the statutory concept of taxable income and the concept of earnings and profits. The latter, although used by Internal Revenue Code, is closer to an accounting concept.[12] Upon recognition of these conceptual distinctions it is possible to discover the rationale for the situation of a cash basis taxpayer, who, though prohibited from accruing debit deductions in computing its taxable income,[13] will be allowed to accrue federal taxes due, but not yet paid, in computing earnings and profits.

The make-up of taxable income is rigorously defined by the Code with an underlying policy of having the taxpayer clearly reflect his income. The Code does not dictate the composition of earnings and profits with the same rigor; this burden is left to the individual taxpayer.[14] All will agree that items determinative of taxable income do not necessarily coincide with those items utilized in calculating earnings and profits.[15] Earnings and profits are based on "actual net income and expenses."[16] "The concept is much closer to actual increases in earned surplus determined by the accountant."[17] Items wholly or partially exempt from income are included in earnings and profits such as tax exempt interest[18] and insurance proceeds on the lives of officers of the corporation.[19] Items which are disallowed as deductions in computation of taxable income are nevertheless subtracted in determining earnings and profits, e.g., federal income taxes[20] and excess charitable contribution.[21]

The deduction of federal income taxes due but not yet paid by a corporate taxpayer who uses the accrual method to report taxable income presents no issue, for he is not disabled from deducting any due but not yet

[10] Ibid.

[11] Int. Rev. Code of 1954 § 301(c)(3)(A).

[12] Emmanuel, supra note 4..

[13] Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948).

[14] Schwanbeck, supra note 4.

[15] Commissioner v. Wheeler, 324 U.S. 542, 546 (1945). The term "does not correspond exactly to taxable income" and it "does not necessarily follow corporate accounting concepts either."

[16] Surrey and Warren, Federal Income Taxation 1238 (1960 ed.).

[17] Ibid.

[18] Charles F. Ayer, 12 B.T.A. 284, 287 (1928).

[19] Rudick, supra note 4, at 880.

[20] Commissioner v. James, 49 F.2d 707 (2d Cir. 1931).

[21] R. M. Weyerhaeuser, 33 B.T.A. 594, 597 (1935). "Under the ordinary method of accounting in computing earnings and profits there will be deducted . . . such items as extraordinary expenses . . . charitable contributions."

paid federal taxes.[22] A problem does arise, as in the instant case, where a corporate taxpayer who keeps his books on the cash basis attempts to accrue federal income taxes due but not yet paid in determining earnings and profits. Regulation 316(a)[23] provides, in the interest of accounting consistency, that the computation of earnings and profits be determined by the same accounting method used in determining taxable income. Therefore a cash basis association as the one in the instant case must utilize the cash basis of accounting in determining earnings and profits. However, an accountant in determining earnings and profits for a cash basis corporation would accrue federal income taxes in determining the actual increase in earned surplus.[24] It is from this conflict between the statutory language and general accounting practice that reason and common sense prevail allowing a corporation which determines its taxable income on the cash basis to accure federal taxes in computing earnings and profits. It is difficult to see how this result subverts the principle of accounting consistency between taxable income and earnings and profits.

If, in the instant case, the corporate trust were not allowed to accrue federal taxes paid in years subsequent to when they were due, then the only time they could make this deduction would be in the year during which they were paid. Such a policy would allow the government to collect a maximum tax from the corporate trust taxed at corporate rates and a maximum tax from the certificate holders by treating the entire trust distribution as ordinary income. Fairness requires that, if in substance what the plaintiff received is a return of capital, it should be non-taxable. A distribution was made on the assumption that it was a trust distribution. A subsequent court decision converted what had been labeled a trust distribution into a dividend. With power of hindsight and a recognition of the economic nature of earnings and profits, that portion of a distribution which exceeds earnings and profits should be treated as a non-taxable return of capital.

In *Drybrough*, where the taxpayer acted wrongly he was allowed to accrue federal taxes to determine how much of the embezzled fund was a constructive dividend. In *Demmon*, the plaintiffs did not act criminally. The denial to the taxpayers of the right to accrue their distributor's federal taxes penalizes them when they have committed no wrong.

Unless there is an express statutory prohibition or policy prohibiting a cash basis taxpayer from accruing federal taxes, the judicial rewriting of section 316[25] so as to allow accrual of federal taxes does not produce an un-

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[22] Commissioner v. James, supra note 20.

[23] Treas. Reg. § 1.316-6(a) (1954).

[24] Supra note 20, at 708.

> In employing the phrase "earnings and profits" . . . we think Congress intended to use the term in the ordinary accounting understanding, and, by that practice, a corporation cannot be expected to have calculated any net income in any year until provision is made for taxes accrued and payable to the United States based on net income for the same year. Montgomery & Stout Accounting Principles 308 (1923).

[25] The Internal Revenue Code of 1954 § 316 defines a dividend as "any distribution made by a corporation . . . (2) out of its earnings and profits of the taxable year (com-

desirable result. Exact logic has given way to the realism of the business community, and the individual taxpayers have been given a "fair break."

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Taxation—Social Security Taxes—Application of Income Tax Regulations.—*S. S. Kresge, Inc. v. United States.*[1]—This action was brought by Kresge for refund of taxes, assessed under the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, for the value of free meals furnished by the employer-taxpayer to its fountain department employees. In 1954, the Commissioner of Internal Revenue had ruled that the value of the meals did not constitute wages in FICA and FUTA computations. Subsequently, in 1957, the Commissioner reversed this ruling in answer to an inquiry by the taxpayer, based on the intermediate passage of Revenue Ruling 57-471.[2] HELD: Income tax regulations are not applicable to FICA and FUTA computations, and even if they did apply, the taxes were properly assessed here since the meals were not given to enable the employees to perform their duties better during their normal working hours.

Section 119 of the Internal Revenue Code of 1954,[3] regarding income tax, reads:

> there shall be excluded from gross income of an employee the value of any meals or lodging furnished . . . for the convenience of the employer, but only if—
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> (1) *in the case of meals*, the meals are furnished on the business premises of the employer, or
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> (2) *in the case of lodging*, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment. (Emphasis supplied.)

For meals to be excluded under subsection (1), all that is required is that they be furnished on the employer's premises, and that the purpose served is the convenience of the employer rather than the compensation of the employee.[4] The requirement of convenience has been deemed to be met when

puted *as of* the close of the taxable year . . .)." (Emphasis supplied.) The court read the words "as of" to mean "as of one point in time"—the close of the taxable year. "Such words [as of] imply accrual. . . ." Supra note 1, at 206.

1 218 F. Supp. 240 (E.D. Mich. 1963).

2 Rev. Rul. 471, 1957-2 Cum. Bull. 630.

[I]t is the opinion of the Internal Revenue Service that the furnishing of such meals is recognized as part of the general understanding of the parties to the employment contract, and that as a practical matter of value of such meals is generally regarded as part of the employees' remuneration.

3 Int. Rev. Code of 1954, § 119.

4 Treas. Reg. § 1-119-1(a)-2 (1956).

Likewise, meals furnished will . . . be deemed to be for the convenience of the employer if the furnished meals serve a business purpose of the employer other than providing additional compensation to the employee.