***Webb v. Commissioner, 69 T. C. 1035 (1978)***

A corporation's earnings and profits are not affected by the redemption of stock at less than its issuance price, and a cash method corporation may not reduce its earnings and profits by accrued but unpaid taxes.

**Summary**

In Webb v. Commissioner, the Tax Court addressed two key issues concerning corporate earnings and profits: the effect of redeeming preferred stock at a discount and whether a cash method corporation can deduct accrued but unpaid taxes from its earnings and profits. The court held that the redemption of stock at a price below its issuance value does not impact the corporation's earnings and profits, as the capital account charge is limited to the actual distribution amount. Additionally, the court ruled that a cash method corporation must deduct taxes from earnings and profits in the year of payment, not accrual, aligning with its accounting method and rejecting contrary circuit court decisions. This case clarifies the treatment of stock redemptions and tax deductions for cash method corporations.

**Facts**

Continental Equities, Inc. , a Florida corporation using the cash method of accounting, issued preferred stock to the Hanover Bank as trustee of the Sheldon I. Rainforth Trust. After a legal dispute, the stock was transferred to the Wirt Peters-Tom Maxey partnership, which later distributed it to its partners, including William C. Webb, the petitioner. In 1968, Continental redeemed 4,250 shares of preferred stock from Gloria Peters, the administratrix of Wirt Peters' estate, for $400,000, less than the original issuance price. The Commissioner assessed deficiencies in Webb's federal income taxes for 1968-1970, prompting Webb to challenge the computation of Continental's earnings and profits, arguing that the redemption should reduce earnings and profits and that accrued taxes should be deducted in the year they accrue.

**Procedural History**

Webb filed a petition in the Tax Court to contest the tax deficiencies determined by the Commissioner. The case proceeded on stipulated facts, focusing on the two unresolved issues regarding the effect of stock redemption on earnings and profits and the timing of tax deductions for a cash method corporation.

**Issue(s)**

1. Whether a redemption of preferred stock at less than its issuance price has any effect on the earnings and profits of the redeeming corporation?
2. Whether Federal income taxes reduce the earnings and profits of a cash method corporation in the year such taxes accrue or in the year of their payment?

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## Holding

1. No, because the charge to the capital account in a stock redemption cannot exceed the actual amount distributed, thus leaving the earnings and profits account undisturbed.
2. No, because a cash method corporation must deduct taxes from earnings and profits in the year of payment, consistent with its accounting method.

## Court’s Reasoning

The court applied Section 312(e) of the Internal Revenue Code, which excludes amounts charged to the capital account from being treated as distributions of earnings and profits in qualified redemptions. For the first issue, the court followed the Jarvis formula to determine the charge to the capital account, but limited it to the actual redemption amount of $400,000, as the stock was redeemed at a discount. This approach was supported by the Ninth Circuit’s decision in United National Corp. , which held that a redemption discount does not increase earnings and profits. Regarding the second issue, the court adhered to its consistent position and the relevant Treasury regulations, rejecting contrary circuit court decisions like Drybrough and Demmon. The court emphasized that a cash method corporation must follow the same accounting method for computing earnings and profits as for taxable income, thus requiring tax deductions in the year of payment.

## Practical Implications

This decision provides clarity for corporations and shareholders on the treatment of stock redemptions and tax deductions in calculating earnings and profits. Corporations redeeming stock at a discount should not expect an impact on their earnings and profits, as only the actual distribution amount affects the capital account. Cash method corporations must align their earnings and profits calculations with their accounting method, deducting taxes in the year of payment rather than accrual. This ruling may influence tax planning strategies and the timing of corporate distributions, particularly for cash method entities. Subsequent cases and tax regulations have generally followed this approach, reinforcing the importance of consistent accounting methods in corporate tax calculations.

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