Cameron v. Commissioner, 105 T. C. 380 (1995)

Earnings and profits of a C corporation converting to an S corporation are fixed at the time of conversion and cannot be adjusted retroactively based on subsequent actual contract costs.

Summary

In Cameron v. Commissioner, the U. S. Tax Court ruled that the earnings and profits of Cameron Construction Co. must be calculated using year-end estimates of long-term contract costs as of the last C corporation year, without retroactive adjustments upon conversion to an S corporation. The company, which used the percentage of completion method, elected S corporation status. The court held that under IRC § 1371(c)(1), the earnings and profits were fixed at the time of conversion and could not be altered by subsequent cost information. This decision affects how S corporations calculate taxable dividends, emphasizing the finality of earnings and profits at the point of conversion.

Facts

Cameron Construction Co. was a C corporation that used the completed contract method for income but was required to calculate earnings and profits using the percentage of completion method. It elected to become an S corporation effective November 1, 1988. During 1989, the company distributed dividends to its shareholders, John and Caroline Cameron, and John and Teena Broadway. The shareholders argued that the company's earnings and profits should be recalculated using actual costs incurred after the conversion, which would lower the taxable amount of the dividends.

Procedural History

The shareholders petitioned the U. S. Tax Court for redetermination of their federal income tax deficiencies for 1989 and 1990. The case was submitted based on a fully stipulated record. The court considered the impact of the S corporation election on the computation of earnings and profits and how to apply the percentage of completion method.

Issue(s)

1. Whether the company's contemporaneous estimates of the cost of completing long-term contracts may be revised retroactively in computing earnings and profits under the percentage of completion method?
2. Whether the company's earnings and profits may be adjusted for taxable years to which its subchapter S election applied?

Holding

1. No, because the percentage of completion method does not allow for retroactive adjustments to year-end estimates of contract costs.
2. No, because under IRC § 1371(c)(1), earnings and profits are frozen at the time of conversion to an S corporation and cannot be adjusted for subsequent years.

Court's Reasoning

The court emphasized that the percentage of completion method is inherently self-correcting, as inaccuracies in cost estimates are corrected in subsequent years' calculations. However, once the company elected S corporation status, its earnings and profits were fixed under IRC § 1371(c)(1). The court rejected the taxpayers' argument for retroactive adjustments, citing the annual accounting principle and the necessity of finality in tax calculations. The court noted that the self-correcting mechanism of the percentage of completion method could not be used post-conversion due to the freeze on earnings and profits mandated by the S corporation election. The court also referenced general tax accounting principles and prior cases to support the non-acceptance of amended returns for retroactive adjustments.

Practical Implications

This decision has significant implications for corporations converting to S status. It clarifies that earnings and profits must be calculated at the time of conversion and cannot be revised based on later actual costs. This affects how dividends are taxed to shareholders and underscores the importance of accurate estimates at the point of conversion. For legal practitioners, this case serves as a reminder to thoroughly assess earnings and profits before advising clients on S corporation elections. Businesses should consider the potential tax implications of converting to an S corporation, especially if they are involved in long-term contracts. Subsequent cases have upheld this principle, further solidifying the rule that earnings and profits are fixed upon S corporation election.