

Distinguish between current and accumulated earnings and profits. Why is it important to make this distinction?

Accumulated earnings are excessive earnings that have accumulated, where current earnings are earnings that are not currently needed for business purposes and have the potential of being accumulated. The reading material also notes the 15% maximum tax rate on dividends that reduces the negative affect of double taxation. That way, current and accumulated earnings cannot be over taxed. Earnings must be divided between these two categories so they are not combined and the corporation pays higher taxes (at least that was my understanding after reading about this, but I may be wrong). If a corporation can avoid accumulated earnings, they can avoid the accumulated earnings tax which is a penalty tax.

Response 2

A corporations calculates the current earning and profits (E & P) balance annually at the end of each year. The accumulated earnings and profits is the total of the current E & P, adding all previous years E & P minus distributions to shareholders. This is a running total of the E & P which distributions can be made from.

Distributions are deducted first from the current E & P then from the accumulated E & P. So the balances need to be separated to distinguish ongoing amounts. If the accumulated E & P is negative but the current E & P is positive, there can still be a distribution from the positive current E & P balance. But if the current E & P is negative and the accumulated E & P is positive, the timing of the distribution will determine if the distributions is treated as a dividend or a return of capital.

Response 3

Current E & P is calculated annually at the end of the year. To calculate E&P you take the company's taxable income or their net operating loss and then adjust it for federal taxes, non-taxable income and any other adjustment that is allowed by Sec 312 of the Treasury Regulations. After all the adjustments are made you are left with the current E&P. If a distribution is to be made it will be made out of the current E&P first only to roll to the accumulated if there isn't enough in the current E&P's coffers.

Accumulated E&P is the sum total of all the undistributed current E&P balances in previous years minus any distribution made from the current E&P and any deficits from previous years. Tracking E&P individually is important to determine the tax liability of the distributions for the sake of the shareholder's in the event there is a change in the stock ownership. Current E&P i allocated on a pro rata basis and accumulated is allotted chronologically. This could mean that there is a larger tax liability for distributions made early in the year in relation to ones issued later in the year and vice-versa.