



May 29, 2007
Pennsylvania Personal Income Tax
No. PIT-07-004
Earnings and Profits
Deconsolidations/Federal Consolidated Groups

ISSUE:

Whether the Department will follow 26 C.F.R. § 1.1502-33(e)(1) in regard to the earnings and profits of a subsidiary corporation that becomes a nonmember of a Federal consolidated group of corporations?

CONCLUSION:

Yes. The Department will eliminate the earnings and profits of a departing subsidiary to the extent they were taken into account by any member under 26 C.F.R. § 1.1502-33.

FACTS:

Taxpayer is a corporation with its headquarters located in Pennsylvania. It was formed as a member of a consolidated group^[1] of corporations for Federal income tax purposes. Members of consolidated groups may not be Federal S corporations. 26 C.F.R. § 1.1502-1(a) & (h), 26 U.S.C. § 1504. All of Taxpayer's stock was subsequently sold to Shareholder. Shareholder made an S Corporation election for both Federal and Pennsylvania income tax purposes effective upon his acquisition of Taxpayer's stock. Shareholder has operated Taxpayer as a Pennsylvania S Corporation since that time.

For Federal income tax purposes, earnings and profits of a "subsidiary" member of a consolidated group are "tiered up" and reflected in the earnings and profits of any member of the consolidated group owning shares of the subsidiary. 26 C.F.R. § 1.1502-33.

In addition, pursuant to Treasury Regulations, earnings and profits of a member corporation leaving a consolidated group are determined as follows:

(e) Deconsolidations -- (1) In general. Immediately before it becomes a nonmember, S's [the subsidiary corporation's] earnings and profits are eliminated to the extent they were taken into account by any member under this section. If S's earnings and profits are eliminated under this paragraph (e)(1), no corresponding adjustment is made to the earnings and profits of P [the parent corporation] (or any other member) under paragraph (b) of this section or to any basis in a member's stock under paragraph (c) of this section. For this purpose, S is treated as becoming a nonmember on the first day of its first separate return year (including another group's consolidated return year).

26 C.F.R. § 1.1502-33(e)(1).

DISCUSSION:

Article III of the Tax Reform Code of 1971, as amended (“the Pennsylvania Personal Income Tax”) contains eight classes of income, and every resident individual, trust and estate is subject to tax on the receipt of income in the various classes. Nonresident individuals, estates and trusts are subject to income tax on income received from sources within Pennsylvania.

72 P.S. §§ 7302(a)&(b) & 7303.

One of the classes of income, dividends, is defined, in pertinent part, as follows:

(f) “DIVIDENDS” means any distribution in cash or property made by a corporation, association, business trust or investment company with respect to its stock out of **accumulated earnings and profits** or out of **earnings and profits** of the year in which such dividend is paid.

72 P.S. § 7301(f)(emphasis added).

“Earnings and profits” are essentially an economic concept of a corporation’s ability to pay dividends without distributing any of the capital contributed by either its shareholders or creditors. It should include all items of income, gains, losses, and deductions resulting from the economic activities of the corporation. Earnings and profits are distinguishable from both Federal taxable income and the financial accounting concept known as earned surplus or retained earnings. *BNA Tax Management Portfolio, Earnings and Profits*, No 762-2nd.

The terms “accumulated earnings and profits” and “earnings and profits” are not defined in the Pennsylvania Personal Income Tax or its regulations.^[2]

However, it has historically been the practice of the Department to allow taxpayers to report the amount of “total ordinary dividends” shown on their Federal Forms 1099-DIV as Pennsylvania dividend income. As such, the Department has taken into account earnings and profits “left behind” by departing corporations when determining the taxability of the distributions of the remaining members of a consolidated group. Therefore, the Department has, as a practical matter, taken the position that the terms “accumulated earnings and profits” and “earnings and profits” have the same meaning for Pennsylvania Personal Income Tax purposes as they do for Federal income tax purposes.

Based on the above stated facts, the earnings and profits of Taxpayer eliminated pursuant to 26 C.F.R. § 1.1502-33(e)(1), are also eliminated for Pennsylvania purposes.

[1] “The term ‘consolidated group’ means a group filing (or required to file) consolidated [Federal income tax] returns for the tax year.” 26 CFR § 1.1502-1(h).

[2] Department regulations state generally that “[i]ncome or gain that is taxable under, as well as income or gain that is exempt from, or not taxable under, this article shall be included in computing earnings and profits.” 61 Pa. Code § 108.1(c)(4).