Earnings and Profits (E&P)

A. What is E&P (earning and profits)?

1. E&P represents

- the upper limit on the amount of dividend income a shareholder must recognize on corporate distributions
- it represents the corporation's economic income (i.e. their “economic ability” to pay dividends) without impairing its capital

2. E & P is computed on an annual basis at the end of the tax year (without reduction for any distributions made during the year)

3. E & P is NOT defined in the tax code – it is similar to retained earnings (a financial accounting concept) but it is not the same

B. The formula to compute current E & P

	Taxable income (computed at end of tax year)
+	Additions to taxable income
–	Subtractions from taxable income
+/-	Timing adjustments
+/-	Accounting method adjustments
=	Current E & P (current E & P deficit)

C. Some common E&P adjustments

1. Additions to taxable income

a) tax-exempt (muni-bond) interest
b) federal income tax refunds
c) excluded life insurance proceeds where corporation is beneficiary (proceeds > cash surrender value of policy)
d) corporate dividends not taxed due to the dividends received deduction
e) the “new” qualified production activities deduction (QPAD)

2. Subtractions from taxable income

a) interest paid on loans to purchase tax-exempt securities (muni-bonds)
b) federal income taxes paid
c) key man life insurance premiums paid (premiums paid > increase in cash surrender value of policy)
d) nondeductible fines & penalties
e) disallowed related party losses

3. Timing adjustments

a) capital losses
   - less: excess capital loss (the capital loss carried forward from the current year that will offset capital gains in future years)
   - add: deduction of capital loss carryforward (the tax benefit received when the capital loss carryforward is used to offset current period capital gains)

b) charitable contributions
   - less: excess charitable contribution (the current period CC in excess of 10% current year's income)
   - add: deduction of charitable contribution carryforward (the tax benefit from the CC carryforward deducted in future years)

Tax year	
2007	2008
less: net capital loss carryforward (not currently deductible) charitable contribution carryforward (CC > 10% corporate income)	add: capital loss carryforward used to offset current period capital gains charitable contribution carryforward (deducted in current year)

4. Accounting method adjustments

a) installment method not allowed for E&P purposes
   - add: 100% of gain in year of sale
   - less: future installment sale gross profit

b) property transactions
   - alternative depreciation system (ADS) must be used for E & P purposes (straight-line over longer recovery period (life))
   - no 30% or 50% bonus depreciation for E & P purposes
   - Sec. 179 election is spread over 5 years
   - recomputed gain (loss) on subsequent sale (using the asset's E & P adjusted basis)

c) percentage of completion method of accounting for long-term contracts must be used for E&P purposes (not the completed contract method)

d) change in the LIFO recapture amount (the excess of FIFO over LIFO)

e) organizational expenses are not deductible for E & P purposes

f) intangible drilling costs must be amortized over 60 months for E & P purposes (deducted currently for tax purposes)