1 T.C. 292 (1942)

A corporation is entitled to a dividends paid credit for the amount paid to retire stock which was originally issued as a stock dividend, but only to the extent that the retirement price exceeds the paid-in capital standing behind the stock.

Summary

F. & R. Lazarus & Company sought a dividends paid credit under Section 27(f) of the Revenue Act of 1936 for retiring preferred stock that had been previously issued as non-taxable stock dividends. The Tax Court held that the company was entitled to a dividends paid credit, but only for the portion of the retirement distribution that exceeded the paid-in capital attributable to the retired shares. The court reasoned that while the prior capitalization of earnings didn't prevent their later distribution as dividends, a portion of the capital account should be considered as representing the original paid-in capital.

Facts

In 1924 and 1929, F. & R. Lazarus & Company issued nontaxable preferred stock dividends based on post-1913 earnings and profits. Prior to the tax year ending January 31, 1937, they redeemed all but 12,000 shares of this preferred stock. During that tax year, the company retired the remaining 12,000 shares, paying $10 per share over par as a premium. The company sought a dividends paid credit for the full amount paid to retire the stock.

Procedural History

The Commissioner of Internal Revenue denied the dividends paid credit claimed by F. & R. Lazarus & Company. The company then petitioned the Tax Court for review of the Commissioner's decision. The Tax Court reversed the Commissioner's determination in part, allowing a dividends paid credit to the extent the distribution exceeded the paid-in capital.

Issue(s)

1. Whether the petitioner is entitled to a dividends paid credit under Section 27(f) of the Revenue Act of 1936 for its fiscal year ending January 31, 1937, by reason of the retirement of preferred stock.
2. Whether the petitioner is entitled to a dividends carry-over credit for the year ending January 31, 1938, as a result of the retirement of stock in the previous year.

Holding

1. Yes, but only in part. The petitioner is entitled to a dividends paid credit for the amount paid to retire the stock which is in excess of the paid-in capital

standing behind such stock because the stock dividends represented earnings and profits accumulated after February 28, 1913, but a portion of the distribution represents a return of capital.

2. Yes, because the dividends paid during the year ending January 31, 1938, were less than the adjusted net income for that year, and the dividends paid in the year ending January 31, 1937, were greater than the adjusted net income for that year.

Court's Reasoning

The court reasoned that Section 27(f) sets up two requirements for a dividends paid credit: a distribution in liquidation, and the distribution must be properly chargeable to earnings and profits accumulated after February 28, 1913. The court found the distribution qualified as a partial liquidation under Section 115(i) because it involved the complete cancellation or redemption of part of the company's stock. Citing *Helvering v. Gowran, 302 U.S. 238*, the court noted the stock dividends were non-taxable when issued.

Relying on Section 115(h) and the Senate Committee's report on the Revenue Act of 1936, the court stated, "earnings and profits in the case at bar remained intact after the stock dividends were issued and hence were available for the payment of dividends." The court rejected the Commissioner's argument that capitalizing earnings prevents those earnings from being distributed as taxable dividends.

However, citing *August Horrmann, 34 B.T.A. 1178*, the court also held that "a proportional part of the paid-in capital must be considered as standing behind each of the shares outstanding at any particular time, so that on redemption of any of them a certain part of the redemption is properly chargeable against capital account." The court meticulously calculated the paid-in capital standing behind each share of stock and allowed the dividends paid credit only for amounts exceeding that capital. The court held that the premium paid above par value should be included in the dividends paid credit, citing *J. Weingarten, Inc., 44 B.T.A. 798*.

Practical Implications

This case clarifies the treatment of distributions in redemption of stock that was initially issued as a stock dividend. It establishes that while the prior capitalization of earnings does not prevent those earnings from being available for later dividend distributions, a portion of any distribution in redemption of such stock is considered a return of capital. This requires a careful calculation of the paid-in capital associated with the redeemed shares to determine the allowable dividends paid credit. This case also provides a methodology for determining how to allocate paid-in capital across various classes of stock and through various recapitalizations. Tax practitioners must meticulously track a corporation's capital structure and history of stock issuances and redemptions to accurately determine the dividends paid credit in these situations. It continues to be relevant for understanding the interplay between stock dividends, capital accounts, and distributions in liquidation for tax purposes.

