Shellabarger Grain Products Co. v. Commissioner, 2 T.C. 1 (1943)

When a corporation distributes assets during partial liquidation, the portion of the distribution properly chargeable to earnings or profits accumulated after February 28, 1913, qualifies for a dividends paid credit.

Summary

Shellabarger Grain Products Co. sold its assets and partially liquidated. The company sought a dividends paid credit for a distribution to shareholders. The IRS disallowed the credit, arguing the distribution was in partial liquidation and not properly chargeable to earnings or profits. The Tax Court held that the distribution was indeed a partial liquidation, but that to the extent the company's earnings exceeded its deficit at the start of the year, a dividends paid credit was allowable. The court detailed the method for allocating the distribution between capital and earnings.

Facts

Shellabarger, an Illinois corporation, sold its assets to Spencer Kellogg & Sons, Inc. for $262,464.74. Prior to the sale, Shellabarger's directors resolved to dissolve the company. Prior to the fiscal year 1936 its outstanding capital stock consisted of preferred and common stock having an aggregate par and stated value of $154,000. During the said fiscal year the petitioner, in accordance with the procedure provided by Illinois corporation law, reduced its outstanding capital stock to 1,810 shares of common stock of a stated value of $50 per share, or .a total of $90,500. This action resulted in the creation of a paid-in surplus of $63,500. At the beginning of the fiscal year 1938 the petitioner's paid-in capital consisted of $90,500 common stock and $63,500 paid-in surplus. At that time the petitioner had no accumulated earnings or profits, but had a deficit of $53,203.27 from operations in prior years. After the sale, the directors declared a dividend of $35 per share, totaling $67,550. Shareholders then formally agreed to dissolve the corporation. Shellabarger claimed a dividends paid credit on its tax return, which the IRS disallowed.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Shellabarger's income and excess profits taxes. Shellabarger petitioned the Tax Court for review of the Commissioner's determination. The case was submitted on a stipulation of facts.

Issue(s)

1. Whether the distribution of $67,550 to Shellabarger's shareholders on August 11, 1938, qualifies for a dividends paid credit under Section 27(a) of the Revenue Act of 1936, or whether it was a distribution in partial liquidation under Section 27(f) and 115(c).

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Holding

1. Yes, in part. Because the distribution was a partial liquidation, the character of the distribution must be determined under section 115 (c) of the act, which provides that "In the case of amounts distributed * * * in partial liquidation * * * the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits." The Tax Court held that a dividends paid credit is allowable to the extent the distribution is properly chargeable to earnings or profits, which is the amount that the earnings or profits of the petitioner for the taxable year exceed the deficit in capital and paid-in surplus existing as of the beginning of the taxable year.

Court's Reasoning

The court reasoned that the distribution fell squarely within the definition of a partial liquidation under Section 115(i) of the Revenue Act of 1936, meaning it was in cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. Therefore, Section 115(c) determined the character of the distribution, not Sections 115(a) and (b) which govern distributions by going concerns. The court noted: "Unlike subsections (a) and (b) of section 115, supra, which govern distributions by corporations other than distributions in liquidation or partial liquidation and require that such distributions be regarded as having been made from earnings or profits to the extent thereof and from most recently accumulated earnings or profits, subsection (c) prescribes no order as between earnings or profits and capital in so far as distributions in liquidation or partial liquidation are concerned, stating merely that the part of such distributions properly chargeable to capital account shall not be considered a distribution of earnings or profits." The court rejected the IRS's argument that earnings must first be applied to absorb the deficit at the beginning of the year and indicated that the proration approach it utilized in *Woodward Investment Co* was applicable here.

Practical Implications

This case clarifies how to determine the dividends paid credit in a partial liquidation scenario. It shows that even in liquidation, distributions can be partly attributable to earnings, thereby qualifying for the credit. The case emphasizes the need to determine the correct amount of earnings and profits, and to allocate distributions properly between capital and earnings in liquidation situations. Later cases rely on *Shellabarger* when dealing with distributions in liquidation and determining the dividends paid credit. The decision highlights that distributions in liquidation do not automatically disqualify for dividends paid credits, requiring careful financial analysis.

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