2 T.C. 422 (1943)

A dividend paid in a corporation's own obligations qualifies for a dividends paid credit to the extent of the obligations' fair market value at the time of payment; if fair market value equals face value, the dividends paid credit is allowed at face value.

Summary

Columbia Conserve Co. declared a dividend on its preferred stock, payable in negotiable promissory notes, to avoid an undistributed profits tax. The Commissioner disallowed the dividends paid credit for the notes, arguing they had no fair market value. The Tax Court, however, found the notes' fair market value equaled their face value based on evidence presented, allowing the credit. A dissenting opinion argued the notes' restrictions and the company's financial condition depressed their value, making the dividend preferential.

Facts

Columbia Conserve Co., an Indiana corporation, declared a 21% dividend on its preferred stock payable in promissory notes maturing in three series (A, B, and C) between 1940 and 1942. The notes bore 5% interest but were subordinate to general creditors, and noteholders waived rights to initiate bankruptcy proceedings. The dividend was intended to minimize the company's undistributed profits tax. The company paid interest on the notes as due and eventually paid off nearly all the notes by the date of the hearing.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Columbia Conserve Co.'s income tax, disallowing the dividends paid credit claimed for the promissory notes, except for a small cash payment. The Tax Court reversed the Commissioner's determination, finding the notes had a fair market value equal to their face value at the time of distribution, thus entitling the company to the full dividends paid credit. The Commissioner had filed an amended answer claiming an increased deficiency based on an error in allowing even the small dividend paid credit.

Issue(s)

1. Whether the fair market value of the promissory notes issued as a dividend was less than their face value at the time of distribution.

Holding

1. No, because the evidence presented established that the fair market value of the notes was equal to their face value at the time of distribution.

Court’s Reasoning

The court focused on Section 27(d) of the Revenue Act of 1936, which dictates that when a dividend is paid in corporate obligations, the dividends paid credit is the lower of the face value or the fair market value of the obligations at the time of payment. The Commissioner argued the notes had no fair market value, justifying the disallowance of the credit. However, the Tax Court, after reviewing the evidence, found that the petitioner demonstrated the notes had a fair market value equal to their face value. The court stated that the Commissioner’s argument that the dividend was preferential only held water if the fair market value was less than face value.

Practical Implications

This case clarifies the valuation of corporate obligations distributed as dividends for purposes of the dividends paid credit. It underscores that the fair market value of such obligations is a factual determination. Taxpayers must present sufficient evidence to demonstrate that the obligations had a fair market value equal to their face value, particularly when the corporation’s financial condition might suggest otherwise. The dissenting opinion serves as a caution, highlighting factors that could depress the fair market value of notes, such as restrictions on transferability, subordination to other debt, and the issuing corporation’s shaky financial status. Later cases would likely scrutinize the specific features of the obligations and the company’s financial health to determine fair market value.

