4 T.C. 955 (1945)

Distributions by a corporation are taxable as dividends only to the extent they are made from accumulated earnings and profits; operating losses can affect the calculation of these earnings.

Summary

R. D. Merrill Co. v. Commissioner involves the tax treatment of distributions from several family-owned corporations to R. D. Merrill Co. in 1936 and subsequent distributions to individual taxpayers in 1937. The central issues concern how to calculate accumulated earnings and profits available for distribution as taxable dividends. This calculation depends on whether prior operating losses should be charged against later earnings, and how distributions in kind (property) affect earnings and profits. The Tax Court addressed the proper accounting for these items to determine the extent to which distributions received by Merrill Co. and its shareholders constituted taxable income.

Facts

R.D. Merrill Co. was a personal holding company. It received distributions from: T. D. & R. D. Merrill, Inc. (T. D. Inc.), Merrill & Ring Canadian Properties, Inc. (Properties, Inc.), and Merrill & Ring Lumber Co. (M. & R. Co.). T. D. Inc. had operating losses from 1913-1926. In 1936, T. D. Inc. distributed cash and stock to Merrill Co. Properties, Inc., received a distribution from Merrill & Ring Lumber Co., Ltd. (Lumber, Ltd.), and distributed cash to Merrill Co. M. & R. Co. distributed cash to Merrill Co. M. & R. Co. had an operating loss in 1932. Eula Lee Merrill and R.D. Merrill received distributions from Merrill Co. in 1937.

Procedural History

The Commissioner determined deficiencies in income tax against R. D. Merrill Co. for 1936 and against the estate of Eula Lee Merrill and R. D. Merrill for 1937. R. D. Merrill Co. petitioned for a redetermination. The cases were consolidated, focusing on the taxability of corporate distributions.

Issue(s)

1. Whether operating losses incurred prior to 1936 by T. D. Inc. should be charged against subsequent earnings and profits in determining the amount available for distribution as taxable dividends in 1936?

2. Whether the accumulated earnings and profits of T. D. Inc. available for distribution in 1936 should be charged with the cost or the fair market value of stock distributed in kind?

3. Whether the distribution to Properties, Inc. by Lumber, Ltd. was a distribution in

partial liquidation?

4. Whether a deficit in accumulated earnings of M. & R. Co. should be charged against subsequent earnings?

5. Whether a distribution in kind made by Merrill Co. in 1935 should be charged against accumulated earnings at fair market value or cost?

Holding

1. No, because the operating losses were incurred from the sale of property based on March 1, 1913, values that exceeded cost. Thus, the losses should not be charged to later earnings.

2. The accumulated earnings should be charged with the cost of the property, because when corporate property is distributed in kind, the cost should be charged against earnings and profits.

3. Yes, because the distribution was one of a series of distributions in complete cancellation or redemption of stock.

4. Yes, because the operating loss was not incurred from the sale of assets that had appreciated in value on March 1, 1913.

5. The distribution should be charged at cost, because when nonwasting corporate property is distributed in kind after it has declined in value below cost, the cost should be charged against earnings and profits.

Court's Reasoning

The court reasoned that under Section 115 of the Revenue Act of 1936, distributions are taxable as dividends only to the extent they are made from accumulated earnings and profits. For T. D. Inc., relying on *Loren D. Sale, 35 B.T.A. 938*, the court held that operating losses based on pre-March 1, 1913, values should not be charged against subsequent earnings. Regarding distributions in kind, the court determined that the cost of the distributed property, rather than its fair market value, should be charged against earnings and profits. The Court reasoned, "When property, as such, is distributed, it is no longer a part of the assets of the corporation, and the investment therein goes with it. That investment is the cost." For Lumber, Ltd., the court found a partial liquidation based on the company's plan to wind down operations, stating, "The liquidation of a corporation is the process of winding up its affairs by realizing upon its assets, paying its debts, and appropriating the amount of its profit and loss." For M. & R. Co., the court distinguished *Helvering v. Canfield, 291 U.S. 163*, finding that the operating loss should reduce subsequent earnings because it did not arise from pre-March 1, 1913, property. The Court said, "It is clear, we think, that nothing had been added to the corporate earnings and profits after March 1, 1913, which could absorb operating losses."

Practical Implications

This case provides guidance on calculating a corporation's earnings and profits for tax purposes, particularly when determining the taxability of distributions to shareholders. It clarifies that operating losses can reduce earnings available for dividends unless those losses are tied to pre-1913 property valuations. It highlights the importance of charging cost, rather than fair market value, against earnings when distributing property in kind. The case also offers a framework for identifying partial liquidations, focusing on the company's intent to wind down rather than continue business as usual. This decision impacts how businesses structure distributions to minimize tax liabilities and how accountants and lawyers advise them.