5 T.C. 108 (1945)

In a corporate reorganization, the accumulated earnings and profits of a predecessor corporation carry over to the successor corporation, impacting the taxability of subsequent distributions to shareholders.

Summary

Crandall-McKenzie & Henderson, Inc. (Crandall-McKenzie), formed to acquire the assets of two predecessor corporations, distributed cash to its shareholders in 1940. The Tax Court addressed whether these distributions constituted taxable dividends or returns of capital. The court held that because Crandall-McKenzie acquired the predecessor corporations' assets in a tax-free reorganization, it also inherited their accumulated earnings and profits. Therefore, the distributions were taxable as ordinary dividends to the extent of those inherited earnings, despite Crandall-McKenzie's own losses.

Facts

Crandall-McKenzie was formed in December 1928 to acquire the assets of Crandall-McKenzie Co. and L. Henderson & Sons, Inc. In exchange, Crandall-McKenzie issued 24,131 shares of its stock and $355,247.75 in cash to the shareholders of the predecessor corporations. Additional stock was sold to new investors, raising approximately $486,893.92. L. Henderson & Sons, Inc. had accumulated earnings and profits of $74,743.62, and Crandall-McKenzie Co. had $329,267.95 in earnings and profits, both accumulated after March 1, 1913. In 1940, Crandall-McKenzie distributed $1.25 per share to its shareholders. Sidney and Carl Munter each owned 10,000 shares and received $12,500 each. Crandall-McKenzie had losses in 1940 and insufficient earnings and profits to cover the distributions if the predecessor corporations' earnings were not included.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Munters' income tax for 1940, treating the distributions as taxable dividends. The Munters petitioned the Tax Court, arguing that the distributions were returns of capital. The Tax Court consolidated the proceedings.

Issue(s)

Whether, upon its organization in 1928, Crandall-McKenzie, in acquiring the assets of two predecessor corporations for stock and cash, also acquired the accumulated earnings and profits of those corporations.

Holding

Yes, because the transaction constituted a tax-free reorganization under Section

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112(i)(1)(A) of the Revenue Act of 1928; therefore, the earnings and profits of the predecessor companies retained their character as earnings and profits in the hands of Crandall-McKenzie.

Court's Reasoning

The Tax Court relied on *Commissioner v. Sansome*, which held that in a tax-free reorganization, the earnings and profits of the predecessor corporation carry over to the successor. The court rejected the petitioners' argument that the introduction of new capital and changes in proportionate stockholdings distinguished the case from *Sansome*. It found that the key factor was that the reorganization resulted in no recognized gain or loss at the time of the exchange, thus preventing a change in the character of accumulated profits. The court distinguished *Campbell v. United States*, in which the Third Circuit had declined to apply the *Sansome* rule where new capital substantially changed the proportionate stockholdings. The Tax Court stated, "that a corporate reorganization which results in no 'gain or loss' under section 202 (c) (2) (42 Stat. 230) does not toll the company's life as continued venture under section 201, and that what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earning or profits' of the successor, or parent, in liquidation."

Practical Implications

Munter v. Commissioner reinforces the *Sansome* rule, clarifying that in tax-free reorganizations, a successor corporation inherits the earnings and profits history of its predecessors. This has significant implications for the taxability of future distributions. Attorneys must analyze the nature of corporate reorganizations carefully to determine whether the *Sansome* rule applies. This case highlights that earnings and profits can carry over even if there are changes in ownership or capital structure. This influences tax planning for corporate distributions and restructurings, emphasizing the need to trace the origins of corporate earnings, even after a reorganization. Later cases have further refined the application of the *Sansome* rule, particularly in situations involving divisive reorganizations and differing classes of stock.

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