5 T.C. 327 (1945)

Earnings accumulated after March 1, 1913, that are capitalized by the issuance of stock dividends retain their character as earnings and are considered ‘dividends’ when distributed, regardless of subsequent accounting treatments.

Summary

A.J. Long, a shareholder of A. Nash Co., received a cash distribution partly attributed to ‘capital surplus,’ which originated from previously capitalized earnings via stock dividends. Long only reported the portion sourced from recent earnings as taxable income. The Commissioner argued the entire distribution was a taxable dividend. The Tax Court sided with the Commissioner, holding that earnings capitalized by stock dividends retain their character as earnings and are taxable as dividends when distributed, aligning with *Commissioner v. Bedford*. This case clarifies that the source of a distribution, not its label, determines its taxability.

Facts

A. Nash Co. capitalized earnings from 1920-1924 by issuing stock dividends. In 1932, the company reduced the par value of its stock, transferring a significant portion of previously capitalized earnings to a ‘capital surplus’ account. In 1939, the company distributed cash to shareholders, allocating a small portion to ‘earned surplus’ and the remainder to ‘capital surplus.’ A.J. Long, owning a significant number of shares, treated only the distribution from ‘earned surplus’ as taxable income.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency against Long, arguing that the entire distribution was taxable as a dividend. Long petitioned the Tax Court for review.

Issue(s)

Whether a cash distribution by a corporation to its shareholders, sourced from ‘capital surplus’ that originated from earnings previously capitalized through stock dividends, constitutes a taxable dividend under Section 115(a) of the Internal Revenue Code.

Holding

Yes, because earnings accumulated after March 1, 1913, that are capitalized by the issuance of stock dividends retain their character as earnings and are taxable as dividends when subsequently distributed, regardless of how the corporation accounts for the distribution.

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Court’s Reasoning

The Tax Court rejected Long’s arguments that the distribution should be treated as a return of capital or partial liquidation. The court emphasized that the key factor is the origin of the funds being distributed. Citing *Commissioner v. Bedford, 325 U.S. 283*, the court stated that “a distribution out of accumulated earnings and profits previously capitalized by a nontaxable stock dividend is taxable as an ordinary dividend under section 115 (a) of the Internal Revenue Code.” The court found that the reduction in par value of the shares was to allow the company to declare and pay cash dividends, which the distribution then accomplished, further pointing away from any intent of liquidation. The fact that the company labeled the surplus account as ‘capital surplus’ was irrelevant; the funds were still derived from past earnings and profits. The Court also cited *Foster v. United States, 303 U.S. 118*; *Commissioner v. Wheeler, 324 U.S. 542* to further reinforce that how the company accounts for the amount does not alter that a part, at least, was “earned income” for Federal tax purposes.

Practical Implications

Long v. Commissioner reinforces the principle that the source of a corporate distribution, not its accounting label, determines its taxability. Attorneys should analyze the origin of funds before advising clients on the tax implications of corporate distributions. This case demonstrates that distributions traced back to previously capitalized earnings are generally taxable as dividends, even if they are characterized as coming from ‘capital surplus.’ It also emphasizes the importance of documenting the intent and purpose behind corporate actions, as the court considered the company’s stated reasons for reducing the par value of its stock.

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