5 T.C. 684 (1945)

When a tax-free reorganization occurs, the transferee corporation “inherits” the transferor’s earnings and profits, making them available for later dividend distributions, regardless of whether the transferred assets were acquired before or after March 1, 1913.

Summary

Mandel v. Commissioner addresses whether distributions made by a building corporation to its preferred stockholders constituted taxable dividends. The building corporation had acquired its assets through a tax-free split-off reorganization from an older company, inheriting a portion of the older company’s accumulated earnings and profits. The Tax Court held that the building corporation did inherit a portion of the old company’s earned surplus, making it available for dividend distribution. The court rejected the petitioners’ argument that the bond issue served to distribute the inherited earnings. This case is significant as it applies the principle established in *Commissioner v. Sansome* to a situation where assets were acquired both before and after March 1, 1913, clarifying how earnings and profits are treated in tax-free reorganizations.

Facts

Mandel Brothers (the old company) was incorporated in 1898 and acquired a retail business. In 1926, it reorganized, transferring its merchandising assets to Mandel Brothers, Inc., and its real estate to Mandel Building Corporation (the building corporation) in exchange for stock and securities. The old company’s net worth at the time was approximately $19 million, with accumulated earnings since March 1, 1913, of about $11 million. The building corporation issued $8 million in bonds and $4 million in stock for the assets it received, a significant portion of which had been acquired by the old company before 1913. In 1939 and 1940, the building corporation made distributions on its preferred stock, which the Commissioner determined were taxable dividends.

Procedural History

The Commissioner assessed deficiencies against the petitioners, who were stockholders of the Mandel Building Corporation, arguing that distributions they received were taxable dividends. The stockholders petitioned the Tax Court for a redetermination of these deficiencies. The Tax Court consolidated several proceedings related to the same issue.

Issue(s)

Whether distributions made by the Mandel Building Corporation to its preferred stockholders in 1939 and 1940 were paid out of earnings and profits accumulated after March 1, 1913, thus constituting taxable dividends.

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Holding

Yes, because the Mandel Building Corporation inherited a portion of the old company's earned surplus through the tax-free reorganization, which was available for dividend distribution, and the subsequent bond issue did not distribute those inherited earnings.

Court's Reasoning

The court relied on the principle established in *Commissioner v. Sansome*, which states that accumulated earnings and profits of a transferor corporation follow its assets to the transferee in a tax-free reorganization. The court rejected the petitioners' argument that earnings should be allocated only to assets acquired after March 1, 1913. It held that the building corporation inherited approximately 35% of the old company's earned surplus, based on the ratio of assets transferred. The court stated, "Capital existing on March 1, 1913, thereafter retains its character, not in the specific asset items in which it is then reflected, but in amount or value." Furthermore, the court found that the bond issuance did not constitute a distribution of earnings and profits, citing Section 203(g) of the Revenue Act of 1926 and Section 115(h) of the Internal Revenue Code, which stipulate that distributions of stock or securities in a reorganization are not considered distributions of earnings or profits.

Practical Implications

Mandel v. Commissioner reinforces the *Sansome* rule, clarifying that in tax-free reorganizations, earnings and profits of the transferor corporation transfer to the transferee. This means that subsequent distributions by the transferee can be treated as dividends to the extent of those inherited earnings, even if the transferee itself has losses or claims the distributions were from paid-in surplus. Attorneys must consider this principle when structuring corporate reorganizations, as it affects the taxability of future distributions to shareholders. The case also demonstrates that a company cannot avoid dividend treatment by arguing specific assets were acquired before 1913 and thus should not be considered when determining the source of distributions. Later cases applying the *Sansome* rule often cite *Mandel* for its clear application of the principle in a complex reorganization scenario.

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