Deficit Corporations v. Commissioner, 8 T.C. 124 (1947)

A corporation's accumulated earnings and profits at the close of a taxable year are determined by considering prior reorganizations and whether state law effectively prohibited dividend payments due to a deficit.

Summary

Deficit Corporations sought a tax credit under Section 26(c)(3) of the Revenue Act of 1936, arguing it had a deficit in accumulated earnings and was legally restricted from paying dividends. The IRS contended that a prior reorganization in 1920, where Deficit Corporations acquired two Wooster companies, transferred the Wooster companies' surplus to Deficit Corporations. The Tax Court held that the 1920 transaction was a reorganization and that Ohio law did not absolutely prohibit dividend payments, thus denying the tax credit. This case clarifies how prior reorganizations impact accumulated earnings and the interpretation of state laws restricting dividend payments.

Facts

In 1920, Deficit Corporations acquired the assets of two Wooster companies in exchange for its own stock.
The two Wooster companies had a combined earned surplus of $67,342.19 at the time of the acquisition.
Deficit Corporations claimed a deficit of $77,068.14 in accumulated earnings and profits as of December 31, 1936.
The IRS argued that the 1920 acquisition was a tax-free reorganization and that the Wooster companies' surplus became part of Deficit Corporations' earned surplus.
Deficit Corporations argued that Ohio law restricted it from paying dividends due to its deficit.

Procedural History

Deficit Corporations petitioned the Tax Court for a redetermination of its tax liability for 1937 and 1938.
The IRS determined deficiencies in Deficit Corporations' income tax for those years.
The Tax Court consolidated the two cases and addressed the primary issue of whether Deficit Corporations had a deficit in accumulated earnings and profits and was restricted from paying dividends.

Issue(s)

Whether the acquisition of the Wooster companies in 1920 constituted a reorganization under the Revenue Act of 1918, thereby transferring the Wooster companies' earned surplus to Deficit Corporations.
Whether Section 8623-38 of the General Code of Ohio prohibited Deficit Corporations from paying dividends during 1937, entitling it to a tax credit under

Section 26(c)(3) of the Revenue Act of 1936.

Holding

No, because the acquisition of assets in exchange for stock was a reorganization under the applicable regulations.
No, because Ohio law did not impose an absolute prohibition on dividend payments; it allowed dividends from sources other than earned surplus.

Court's Reasoning

The Tax Court relied on Article 1567 of Regulations 45, interpreting the Revenue Act of 1918, which stated that when corporations unite their properties through the sale of assets in exchange for stock, and the acquired company dissolves, no taxable income is received if the consideration is stock of no greater aggregate par value. This regulation effectively treated the 1920 transaction as a tax-free reorganization. The court reasoned that while the Revenue Act of 1918 did not define "reorganization," the regulation provided sufficient authority to conclude that the transfer of assets and subsequent dissolution of the Wooster companies constituted a reorganization for tax purposes, thereby transferring the earned surpluses.
Regarding the dividend restriction, the court interpreted Section 8623-38 of the General Code of Ohio. The court noted that while the Ohio statute restricted dividend payments when a corporation was unable to meet its obligations, it did not entirely prohibit dividend payments. The evidence indicated that the petitioner had paid-in surplus from which dividends could have been paid, and the statute did not prevent dividends from being paid out of paid-in surplus. Since Section 26(c)(3) required an absolute prohibition on dividend payments, the court found that Deficit Corporations did not meet the requirements for the tax credit. The court cited Great Lakes Coca Cola Bottling Co. v. Commissioner, noting that earned surplus could not be reduced by dividends paid when there were no accumulated earnings from which to pay those dividends.

Practical Implications

This case highlights the importance of understanding the tax implications of corporate reorganizations, particularly concerning the transfer of earnings and profits. It emphasizes that regulations interpreting older revenue acts can still have relevance in determining the tax treatment of transactions.
The decision demonstrates that for a corporation to claim a tax credit based on restrictions on dividend payments, the restriction must be an absolute prohibition imposed by law or regulatory order. Mere limitations or conditions on dividend payments are insufficient. This encourages careful analysis of state laws and regulatory orders to determine if they meet the strict requirements for such tax credits.
Later cases might distinguish Deficit Corporations by focusing on the specific language of state statutes or regulatory orders to determine whether they impose an

absolute prohibition on dividend payments, or by examining the specific facts of a reorganization to determine if it meets the definition under the applicable revenue act and regulations. The case is a reminder that tax law is highly fact-specific and dependent on the prevailing legal and regulatory landscape.

