8 T.C. 831 (1947)

A corporation does not realize taxable income when it distributes, as a dividend in kind, assets previously written off as worthless, even if those assets subsequently generate income for the shareholders.

Summary

First State Bank of Stratford declared a dividend in kind, distributing to its shareholders notes that had been previously written off as worthless and deducted as bad debts for tax purposes. After the distribution, the shareholders collected payments on these notes. The Commissioner argued that the bank realized taxable income from both the distribution and the subsequent collections. The Tax Court, however, held that under the *General Utilities* doctrine, the bank did not realize income from distributing the notes, and the subsequent recoveries were taxable to the shareholders, not the bank. This case illustrates that the assignment of property, even if previously written off, differs from the assignment of income.

Facts

First State Bank of Stratford, a Texas corporation, had previously charged off certain notes as worthless, taking corresponding deductions on its income tax returns. On October 17, 1942, the bank's board of directors declared a dividend in kind, distributing these previously written-off notes to its shareholders. The notes, totaling $111,254.38, were considered to have some potential for collection, while those considered completely uncollectible were not included in the dividend. The notes were endorsed to W.N. Price, acting as a special representative for the shareholders. Amounts collected on the notes after the distribution were deposited into an account designated "W.N. Price, Special."

Procedural History

The Commissioner of Internal Revenue assessed a deficiency against First State Bank, arguing that the bank realized taxable income when it distributed the previously written-off notes and when the shareholders collected payments on those notes. The bank petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

1. Whether the petitioner realized taxable income from the declaration and payment of a distribution in kind of notes which it had in a previous year charged off as worthless, the deduction being allowed?

2. Whether collections made on the notes, after such dividend in kind, constituted taxable income to the petitioner?

Holding

1. No, because distributing property as a dividend in kind does not result in taxable income to the corporation, even if the property has appreciated in value since acquisition.

2. No, because after the distribution of the notes as a dividend in kind, subsequent collections on those notes are income to the shareholders, not the corporation.

Court's Reasoning

The court relied heavily on *General Utilities & Operating Co. v. Helvering*, which established that a distribution in kind of property does not result in taxable gain to the corporation. The court rejected the Commissioner's argument that the prior write-off of the notes distinguished this case. While the Commissioner contended that the bank was essentially assigning the right to receive future income, the court emphasized that the bank distributed the notes themselves, not just the right to future income. "Not mere interest coupons, but the notes, with all their rights, were assigned to the stockholders. The property which produced the income was assigned – the tree and the fruit." The court distinguished the case from situations where a taxpayer merely assigns income rights while retaining ownership of the underlying asset. The court also rejected the Commissioner's argument that the bank retained control over the notes after distribution, finding that the stockholders had true ownership and control.

Practical Implications

This case illustrates the distinction between assigning income and assigning property. Even if an asset has a zero basis due to prior write-offs, distributing that asset as a dividend in kind can shift the tax liability for future income generated by that asset to the shareholders. Attorneys should advise corporations that distributing property, rather than merely assigning the right to receive income from that property, can have significant tax consequences. The case remains relevant for understanding the tax treatment of in-kind distributions and the limitations on assigning income to avoid taxation. While the *General Utilities* doctrine has been repealed, the case still provides insight into the characterization of assets and the assignment of income principles. Subsequent cases distinguish *First State Bank* by focusing on whether the corporation truly relinquished control over the distributed assets.

