8 T.C. 1224 (1947)

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A corporation’s gain from successfully asserting a statute of limitations defense against a debt claim increases its earnings and profits, potentially leading to taxable dividend income for shareholders when those earnings are distributed.

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Summary

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The petitioner, a shareholder in a family-owned building company, received distributions in 1940 and 1941. The IRS determined these distributions were taxable dividends. The company had previously owed $400,000 to the petitioner’s mother, secured by a mortgage. Although the mother verbally indicated she wouldn’t collect the debt, she never formally forgave it. After her death, the executor sued to collect, but the company successfully claimed the statute of limitations. The Tax Court had to determine whether the distributions were taxable dividends or a non-taxable return of capital.

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Facts

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The I. N. Van Nuys Building Co. was formed in 1911.r
Susanna H. Van Nuys (petitioner’s mother) loaned the company $400,000 in 1913, evidenced by a promissory note and secured by a mortgage.r
Susanna stated to family members that she did not intend to enforce the note’s collection but never formally cancelled it.r
Interest was paid on the note until Susanna’s death in 1923.r
Susanna’s will didn’t mention the note. Her estate initially valued the note at zero but the IRS challenged this valuation.r
The executor of Susanna’s estate sued the building company to collect on the note; the company successfully defended based on the statute of limitations.r
In 1938, the company transferred $400,000 to

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