9 T.C. 392 (1947)

A corporation undergoing liquidation can claim a dividends paid credit for distributions to shareholders to the extent those distributions are properly charged to earnings and profits, not capital, and are made to avoid personal holding company surtaxes.

Summary

St. Clair Estate Co., a personal holding company in voluntary dissolution, sought dividends paid credits to reduce its surtax liability. The Tax Court addressed whether dividends declared and paid under court supervision during liquidation qualified for the credit. The court held that dividends paid to avoid surtaxes were creditable to the extent of the company's net income, but prior dividends constructively received and distributions not pro rata did not qualify. This case illustrates the interplay between corporate liquidations, dividend distributions, and tax avoidance motives.

Facts

The St. Clair Estate Co. was a family-owned personal holding company. A dispute among the shareholders led to a lawsuit and court-supervised voluntary dissolution. During the process, the company continued to receive income from investments. To avoid personal holding company surtaxes, the company sought court approval to distribute dividends to its shareholders. The company declared and paid dividends in 1938, 1939 and 1940. The IRS disallowed most of the company's claimed dividends paid credits for those years.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioner's income tax and personal holding company surtax for the years 1937-1940. St. Clair Estate Co. petitioned the Tax Court for a redetermination of these deficiencies. The Tax Court reviewed the Commissioner's determinations regarding the dividends paid credit and the characterization of certain dividends as return of capital.

Issue(s)

1. Whether the petitioner was entitled to a dividends paid credit for 1937 based on a dividend declared in 1936 but paid in 1937?

2. Whether the petitioner was entitled to a dividends paid credit for 1938 when a court order restrained the payment of dividends?

3. Whether the petitioner was entitled to a dividends paid credit for 1939 and 1940 for dividends paid under court supervision during liquidation to avoid personal holding company surtaxes?

4. Whether certain dividends received by the petitioner in 1938 should be excluded from taxable income as a return of capital?

Holding

1. No, because the dividend was constructively received by the stockholders in 1936, and the corporation was entitled to a dividends paid credit that year, not in 1937.

2. No, because the court order prevented the payment of dividends, and the distribution to one shareholder (Cora) was not pro rata.

3. Yes, because the distributions were properly chargeable to earnings and profits and were made to avoid the surtaxes on undistributed income of personal holding companies.

4. Yes, because the stipulated facts showed that a portion of the dividends received constituted a return of capital.

Court’s Reasoning

Regarding the 1937 dividend, the court reasoned that the dividend was declared and made available to shareholders in 1936; therefore, it was constructively received in 1936, precluding a dividends paid credit in 1937. For 1938, the court emphasized that the restraining order prevented actual payment of the dividend, and the distribution to Cora was not pro rata, violating the requirements for a dividends paid credit. As to 1939 and 1940, the court acknowledged the technical liquidation but focused on the distributions’ purpose: to avoid personal holding company surtaxes by distributing earnings. The court distinguished cases involving actual liquidation of assets and found that the distributions were properly chargeable to earnings rather than capital. The court stated, “Regardless of the form of words used in the court orders authorizing the payment of the dividends in question, and the corporate resolution declaring them, it is evident from the entire record before us that petitioner, its directors, and the court having supervision over its winding up intended those distributions to be only such distributions as would conform with the economic and fiscal policies encouraged by the personal holding company provision of the Federal revenue laws and would distribute its earnings to its stockholders during the long period of time between petitioner’s decision to dissolve and its actual liquidation.”
For the return of capital issue, the court relied on the stipulated facts, which the Commissioner did not dispute.

Practical Implications

This case clarifies the requirements for a dividends paid credit in the context of corporate liquidations and personal holding companies. It underscores the importance of: (1) actual payment of dividends, not merely declaration; (2) pro rata distributions to all shareholders; and (3) demonstrating that distributions are properly charged to earnings and profits, especially when a company is undergoing liquidation. The case also highlights that a tax avoidance motive, when aligned with the intent of the tax law (distributing earnings to shareholders), can be a valid factor in determining eligibility for the dividends paid credit. Later cases would cite this case in determining whether or not a distribution in liquidation should be treated as a dividend for tax purposes.

