10 T.C. 435 (1948)

Withdrawals by a parent corporation from a subsidiary are treated as dividends for tax purposes only in the year a formal dividend is declared, not in the years when the funds were actually withdrawn, unless the intent at the time of withdrawal was clearly to distribute profits.

Summary

Wilputte Coke Oven Corporation (petitioner) sought to treat cash withdrawals from its Canadian subsidiary in 1938 and 1939 as dividends in those years for excess profits tax calculations. The Tax Court held that the withdrawals were not dividends until 1940, when a formal dividend was declared. The court reasoned that the initial book entries treated the withdrawals as loans, and the petitioner's tax returns did not report them as dividends until 1940. This deferred characterization impacted the petitioner's excess profits tax base period net income and carry-over credits.

Facts

The petitioner's wholly-owned Canadian subsidiary undertook contracts in Canada in 1937 and 1938, generating a profit.
The petitioner advanced initial funds and provided services, charging these to the subsidiary.
From September 1937 to May 1940, the subsidiary made cash payments to the petitioner.
After October 1938, these payments exceeded the subsidiary's debt to the petitioner.
In June 1937, both companies opened intercompany accounts, treating initial transfers as loans from the petitioner.
No formal dividend was declared until July 22, 1940.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the petitioner's excess profits tax for 1941.
The Commissioner disallowed the petitioner's claimed excess profits credit, computed by including the 1938 and 1939 withdrawals as income. The petitioner argued the withdrawals were dividends in the years they were made, thus affecting its tax liability. The Tax Court ruled in favor of the Commissioner, determining that the withdrawals should be treated as a dividend only in 1940.

Issue(s)

Whether net amounts withdrawn by a parent corporation from its subsidiary in 1938 and 1939 constituted dividends in those years, or only in 1940 when a formal dividend was declared.

Holding

No, the net cash withdrawals made in 1938 and 1939 by the petitioner from its Canadian subsidiary were not dividends in those years when received because the contemporaneous accounting treatment and tax filings indicated they were treated as loans until the formal dividend declaration in 1940.

Court's Reasoning

The court relied on the principle that withdrawals are deemed income when the character of the withdrawal changes from a loan to a distribution of profits. It cited Wiese v. Commissioner, stating that when a shareholder makes a "permanent withdrawal of funds," it's deemed income at withdrawal, but if it's a loan later canceled, income accrues upon cancellation.

The court noted that the intercompany accounts initially recorded the transfers as loans, and the petitioner's balance sheets showed the subsidiary's balance as an asset and the petitioner's as a liability.

The petitioner's tax returns didn't report dividends from the subsidiary until 1940. The court emphasized that the petitioner's actions before anticipating increased tax liability reflected their true intent.

The court distinguished cases cited by the petitioner, noting that in those cases, the Commissioner initially treated withdrawals as dividends, and the taxpayer failed to prove otherwise. Here, the Commissioner accepted the petitioner's original treatment, and the petitioner bore the burden of proving it wrong. The court also highlighted that the petitioner had the power to declare dividends at any time but didn't do so in 1938 or 1939. As the court pointed out, "It is important that courts do not go too far in relieving the taxpayer of his burden of proof in cases such as this, where both the facts and the evidence are peculiarly subject to the control and knowledge of the taxpayer."

Practical Implications

This case underscores the importance of consistent accounting treatment and tax reporting when dealing with intercompany transfers. The case emphasizes that the intent and characterization of the transfer at the time it occurs are critical in determining whether it is a loan or a dividend. Taxpayers cannot retroactively reclassify transactions to minimize tax liability, especially when their initial actions and records contradict the revised characterization. This ruling affects how corporations manage intercompany transactions and plan their tax strategies, reinforcing the need for contemporaneous documentation and clear intent.

