T.C. Memo. 1950-21

Under Section 721 of the Internal Revenue Code, to exclude net abnormal income from adjusted excess profits, a taxpayer must demonstrate that the income is attributable to specific other years based on the events that originated the income.

Summary

Stitzel-Weller Distillery sought to exclude $7,500 from its adjusted excess profits net income for the year ending June 30, 1943, arguing it was abnormal income attributable to prior years under Section 721 of the Internal Revenue Code. The income stemmed from a settlement related to a whiskey bottling contract dispute. The Tax Court upheld the Commissioner's determination, finding that Stitzel-Weller failed to adequately show the income's attribution to specific prior years based on the originating events, such as the timing and extent of unbottled whiskey withdrawals. Additionally, the court determined that the distribution of warehouse receipts to shareholders was a bona fide dividend in kind, and the subsequent sale was made by the shareholders, not the corporation.

Facts

Stitzel-Weller Distillery (petitioner) had a contract with Bernheim Distilling Company for Bernheim to purchase whiskey manufactured by Stitzel-Weller. A modification contract in June 1943 resulted in Stitzel-Weller receiving $10,000 from Bernheim, netting $7,500 after expenses. This payment settled several claims, including disputes over bottling operations. Specifically, Bernheim had ceased using Stitzel-Weller's bottling plant to the distillery's dissatisfaction. The petitioner also distributed warehouse receipts for 1,152 barrels of whiskey to its stockholders as a dividend in kind.

Procedural History

Stitzel-Weller sought to exclude the $7,500 from its adjusted excess profits net income, allocating it over the period of the original contract. The Commissioner denied this exclusion. The Commissioner also determined that the profit from the sale of the warehouse receipts was taxable to the corporation, not the shareholders. Stitzel-Weller then petitioned the Tax Court for review.

Issue(s)

1. Whether the $7,500 received by Stitzel-Weller was abnormal income attributable to other years under Section 721 of the Internal Revenue Code, thus excludable from adjusted excess profits net income.

2. Whether the sale of warehouse receipts for whiskey constituted a sale by the corporation or a sale by its shareholders after a valid dividend in kind distribution.

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Holding

1. No, because Stitzel-Weller failed to adequately demonstrate that the abnormal income was attributable to specific prior years based on the events in which the income had its origin.

2. No, the sale was made by the shareholders, because the corporation had validly distributed the warehouse receipts as a dividend in kind, and the subsequent sale was negotiated and executed by the shareholders through their agent.

Court's Reasoning

Regarding the Section 721 issue, the court emphasized that merely having a claim arising from contract interpretations does not automatically attribute the settlement to the entire contract period. The court cited Regulation 112, Section 35.721-3, stating that abnormal income must be attributed to other years "in the light of the events in which such items had their origin." The court found that Stitzel-Weller failed to provide sufficient evidence, such as the timeline and volume of unbottled whiskey withdrawals, to accurately allocate the income to prior years. The court also noted that the settlement encompassed more than just lost bottling profits, making attribution even more complex. The court reasoned that if the income was earned throughout the contract period, it wouldn't be considered abnormal. To avail itself of the benefit of Section 721, Stitzel-Weller had to show that the net abnormal income was attributable to other years "in the light of the events in which such items had their origin," which it failed to do.

Regarding the dividend in kind issue, the court applied the principle from *Commissioner v. Court Holding Co.*, 324 U.S. 331, that "the incidence of taxation depends upon the substance of a transaction" and that a sale by one person cannot be transformed into a sale by another through mere formalism. However, the court distinguished this case, finding credible, uncontradicted testimony that no agreement regarding the sale existed before the dividend declaration. The court found that by endorsing and delivering the warehouse receipts, Stitzel-Weller transferred title to its stockholders. The court also noted that Schenley's (the purchaser) failure to sue Stitzel-Weller for breach of contract was likely due to the high demand for whiskey at the time, rather than a pre-existing agreement.

Practical Implications

This case illustrates the importance of meticulously documenting the factual basis for attributing abnormal income to specific prior years when seeking relief under Section 721. Taxpayers must provide concrete evidence linking the income to specific events in those prior years, not just the existence of a long-term contract. The case also reaffirms the principle that a dividend in kind is recognized for tax purposes if the corporation genuinely relinquishes control over the asset and the shareholders independently negotiate and execute the sale. This highlights the

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necessity of avoiding pre-arranged sales agreements before declaring a dividend to ensure the transaction is treated as a sale by the shareholders, not the corporation. It further provides an example of how courts will scrutinize transactions for economic substance over form, but also respect the form when the taxpayer can demonstrate its validity.

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