Scaife Co. v. Commissioner, 47 B.T.A. 964 (1942)

A pro rata stock dividend of common stock on common stock, where surplus is transferred to capital on the books and stock certificates are issued, is not considered a distribution of earnings and profits and does not increase equity invested capital for tax purposes.

Summary

Scaife Co. petitioned the Tax Court, arguing that a series of transactions in 1917 resulted in an increase in its equity invested capital. The company claimed that the declaration of a dividend followed by stockholders using those funds to purchase stock constituted property paid in for stock. The Tax Court disagreed, finding that the transactions were essentially a pro rata stock dividend, which does not increase equity invested capital. Furthermore, the taxpayer failed to prove the basis for loss of any property transferred. The court also upheld the Commissioner’s disallowance of certain additions to a reserve for bad debts.

Facts

In 1917, Scaife Co. undertook a series of transactions involving its stockholders. The company declared a dividend. Simultaneously, stockholders subscribed for additional shares of stock. The stockholders then used the declared dividends to pay for the new stock. Scaife Co. argued this constituted “undivided property” being paid in for stock, thereby increasing its equity invested capital under section 718(a) of the Internal Revenue Code.

Procedural History

Scaife Co. challenged the Commissioner’s determination that the 1917 transactions did not increase its equity invested capital and the disallowance of deductions for additions to a bad debt reserve. The case was brought before the Board of Tax Appeals (now the Tax Court).

Issue(s)

1. Whether the declaration of a dividend, immediately followed by stockholders using the dividend to purchase new stock, constitutes property paid in for stock, thus increasing equity invested capital under section 718(a) of the Internal Revenue Code.
2. Whether the Commissioner erred in disallowing deductions claimed for additions to a reserve for bad debts.

Holding

1. No, because the transaction was, in substance, a pro rata stock dividend of common on common, which is not considered a distribution of earnings and

profits. Furthermore, the taxpayer failed to prove the basis for loss of any property allegedly transferred.
2. No, because the evidence showed that the reserve for bad debts was already ample, and the additions were not necessary.

Court's Reasoning

The court reasoned that the transactions were steps in an integrated and indivisible plan to issue a stock dividend. Quoting *Jackson v. Commissioner*, 51 Fed. (2d) 650, the court emphasized looking through the form to the substance of the transaction. The court noted, "It is fair to conclude from the entire record that the whole arrangement was agreed to in advance. The results were accomplished by transferring $125,000 from surplus to capital on the books and by the issuance of stock certificates." Such a pro rata stock dividend does not constitute a distribution of earnings and profits under Section 115(h) I.R.C. citing *Eisner v. Macomber*, 252 U.S. 189 and *Helvering v. Griffiths*, 318 U.S. 371. Additionally, the court emphasized that the petitioner failed to provide evidence of the basis for loss of any property supposedly paid in for the stock, a requirement under Section 718(a)(2). Regarding the bad debt reserve, the court found the Commissioner's determination was supported by the evidence, noting the history of the reserve and the lack of necessity for the additional amounts claimed as deductions.

Practical Implications

This case clarifies the requirements for a valid transaction that increases equity invested capital for tax purposes. It reinforces the principle of substance over form in tax law. Taxpayers cannot artificially inflate their equity invested capital through circular transactions like declaring dividends and then using them to purchase stock, especially if the transactions lack economic substance. The case highlights the importance of documenting the basis for loss of any property contributed to a corporation in exchange for stock. Furthermore, it demonstrates the Commissioner's discretion in determining the reasonableness of additions to a reserve for bad debts and the taxpayer's burden to prove the necessity of such additions.

