12 T.C. 110 (1949)

When a corporation distributes property in kind to its stockholders (not out of earnings and profits), the basis for reducing its equity invested capital is the corporation's basis in the property at the time of distribution, typically the cost of acquisition.

Summary

Reynolds Spring Company distributed stock of General Leather Company to its shareholders as a liquidating dividend. This distribution was not made from accumulated earnings or profits. The Tax Court addressed the question of what amount Reynolds Spring should use to reduce its equity invested capital for excess profits tax purposes. The court held that the reduction should be based on Reynolds Spring's cost basis in the General Leather Company stock, not the fair market value at the time of distribution. This decision emphasized the importance of using the original cost basis when determining the reduction in equity invested capital resulting from such distributions.

Facts

In 1924, Reynolds Spring Company acquired all the outstanding common stock of General Leather Company for $2,412,875.83. In 1931, Reynolds Spring distributed the General Leather Company stock to its shareholders as a liquidating dividend. At the time of the distribution, the fair market value of the General Leather Company stock was $742,830. Immediately prior to the distribution, Reynolds Spring had an earned surplus deficit of $698,760.84. The distribution was not made from accumulated earnings or profits.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Reynolds Spring's excess profits tax. The Commissioner argued that Reynolds Spring should reduce its equity invested capital by the cost of the General Leather Company stock ($2,412,875.83), while Reynolds Spring contended the reduction should be based on the fair market value at the time of distribution ($742,830). The Tax Court sided with the Commissioner.

Issue(s)

Whether the amount by which Reynolds Spring's equity invested capital should be reduced, due to the distribution of General Leather Company shares, is the cost of the stock to Reynolds Spring or the fair market value of the stock at the time of distribution.

Holding

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Yes, the amount by which Reynolds Spring's equity invested capital should be reduced is the cost of the stock to Reynolds Spring because the court reasoned that the statute requires using the unadjusted basis for determining loss upon sale or exchange when property is paid in for stock, and the same basis should logically apply when reducing invested capital due to an in-kind distribution.

Court's Reasoning

The Tax Court reasoned that equity invested capital is a statutory concept, and while the statute doesn't explicitly state the basis for reducing equity invested capital for in-kind distributions, it does specify the basis for including property paid in for stock: the unadjusted basis for determining loss upon sale or exchange. The court stated, "Logic and common sense would seem to indicate that the same basis be used here in reducing the invested capital where the distribution is in kind, not out of earnings and profits." The court supported its reasoning by citing similar cases and legal treatises that emphasize the importance of using cost basis in such calculations. The court also quoted from R.D. Merrill Co., stating, "When property, as such, is distributed, it is no longer a part of the assets of the corporation, and the investment therein goes with it. That investment is the cost…"

Practical Implications

This case clarifies that when a corporation distributes property in kind (not from earnings and profits), the cost basis of the distributed property determines the reduction in equity invested capital. This has direct implications for calculating excess profits tax credits. Legal practitioners should analyze the original cost basis when determining the impact of such distributions on a corporation's tax liabilities. Subsequent cases and IRS guidance have generally followed this principle, reinforcing the importance of maintaining accurate records of asset costs for tax purposes. This ruling affects how businesses structure distributions and manage their equity invested capital for tax optimization.

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