13 T.C. 984 (1949)

Capital impaired by pre-March 1, 1913, operating losses must be restored out of subsequent earnings or profits before taxable dividends can be distributed.

Summary

This case addresses whether a corporation's capital, impaired by operating losses before March 1, 1913, must be restored out of subsequent earnings before distributions to stockholders can be considered taxable dividends. The Tax Court held that such capital impairment must be restored. The court also addressed whether the transfer of treasury stock in exchange for the cancellation of debt resulted in a reduction of the corporation's operating deficit. Finally, the court considered whether operating deficits of liquidated subsidiaries transferred to the parent company reduce the parent's accumulated earnings.

Facts

Petitioners were stockholders of J. D. & A. B. Spreckels Co. (Spreckels Co.). Spreckels Co. made distributions to its stockholders during 1938-1940. The IRS determined these distributions were fully taxable dividends. Spreckels Co. had acquired assets from subsidiaries, some of which had operating deficits as of March 1, 1913. Oceanic Steamship Co. and Kilauea Sugar Plantation Co. had operating deficits at March 1, 1913. Monterey County Water Co. and Seventh and Hill Building Corporation, subsidiaries of Spreckels Co., had operating deficits accumulated since March 1, 1913, when they were liquidated.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax. The petitioners contested these determinations, arguing that the distributions were partly distributions of capital, not fully taxable dividends. The Tax Court consolidated the cases.

Issue(s)

1. Whether the transfer by Oceanic Steamship Company on November 16, 1912, of shares of its stock to J. D. Spreckels & Bros. Company in consideration for the cancellation of notes reduced Oceanic's operating deficit.
2. Whether the operating deficits of Oceanic Steamship Company and Kilauea Sugar Plantation Company as of March 1, 1913, must be restored by subsequent earnings or profits in determining the amount of earnings or profits available for dividends.
3. Whether the operating deficits of Seventh and Hill Building Corporation and Monterey County Water Company, wholly-owned subsidiaries of J. D. and A. B. Spreckels Company, were transferred to J. D. and A. B. Spreckels Company at the time of the liquidation of the said wholly-owned subsidiaries.

Holding

1. No, because the issuance of the treasury shares was a capital-producing transaction and did not result in a restoration of impaired capital through realization of profits.
2. Yes, because impaired capital as of March 1, 1913, must be restored out of earnings or profits before there can be any accumulation of earnings or profits from which taxable dividends can be paid.
3. No, because the Supreme Court in *Commissioner v. Phipps, 336 U.S. 410*, held that deficits of subsidiaries do not reduce the parent's accumulated earnings in this type of liquidation.

Court's Reasoning

Regarding the restoration of capital, the court reasoned that fundamental corporation law dictates that dividends can be declared only out of surplus profits, and capital must be regarded as a liability. Referring to *Commissioner v. Farish & Co.*, the court stated, "It is well settled that impairment of capital or paid in surplus of a corporation which resulted from operating losses must be restored before any earnings can be available for distribution to the stockholders." The court found no basis in the statute to conclude that Congress, in recognizing the equity of stockholders as to pre-March 1, 1913, earnings, intended to legislate with respect to the restoration or nonrestoration of capital. Regarding the transfer of stock, the court reasoned that Oceanic did not realize gain as the stock issuance was a capital-producing transaction. Regarding the deficits of subsidiaries, the court relied on *Commissioner v. Phipps*, holding that such deficits do not serve to reduce the parent company's accumulated earnings.

Practical Implications

This case clarifies the treatment of pre-March 1, 1913, operating losses in determining the taxability of corporate distributions. Attorneys must consider whether a corporation's capital was impaired before March 1, 1913, and ensure that such impairment is restored before treating distributions to shareholders as taxable dividends. The decision highlights the importance of analyzing the source of corporate distributions and understanding the historical financial condition of the corporation. It also confirms that *Phipps* prevents subsidiary deficits from automatically reducing the parent's earnings and profits in a tax-free liquidation, a crucial consideration in corporate reorganizations and liquidations.

