15 T.C. 503 (1950)

A distribution by a corporation (A) to its sole stockholder, another corporation (B), out of realized pre-1913 appreciation exceeding B's basis in A's stock, is taxable as a dividend when redistributed by B to its stockholders, and previously declared but unpaid dividends are taxable when later paid if the corporation has sufficient earnings in the year of payment.

Summary

The Tax Court addressed two key issues: (1) whether distributions from Cummer Sons Cypress Co. (Cypress), sourced from pre-1913 appreciation realized by Cummer Co. and initially distributed to Cypress, retained their tax-exempt status when Cypress redistributed them to its shareholders (the petitioners via the Cummer Trust); and (2) whether dividends declared by Cummer Lime Co. in 1926 but paid in 1943 and 1945 were taxable as dividends in the years paid, despite the prior declaration. The court held that the distributions lost their tax-exempt status upon redistribution and that the later dividend payments were taxable due to adequate corporate income in the years they were actually paid.

Facts

Cummer Co. possessed timberlands acquired before March 1, 1913, which appreciated significantly by that date. Cummer Co. distributed realized pre-1913 appreciation to its sole stockholder, Cypress. In 1941, Cypress distributed funds to the Cummer Trust, which then distributed to the petitioners. The petitioners treated these distributions as non-taxable. In 1926, Cummer Lime Co. declared a large dividend but didn't fully pay it out. The unpaid portions were carried on the books as "accounts payable" to stockholders. Payments on these accounts were made in 1943 and 1945, years in which Cummer Lime had sufficient net income.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against the petitioners, arguing that the distributions from Cypress and the dividend payments from Cummer Lime were taxable income. The petitioners challenged these assessments in the Tax Court.

Issue(s)

1. Whether a distribution by a corporation (Cummer Co.) to its sole stockholder corporation (Cypress) out of realized pre-1913 appreciation, exceeding the stockholder's basis, retains its tax-exempt status when redistributed by the stockholder corporation to its own shareholders (via the Cummer Trust).
2. Whether distributions to shareholders in 1943 and 1945, from dividends declared in 1926, are taxable as dividends under Internal Revenue Code Section 115(b), given the company's adequate net income in those years.

© 2025 SCOTUSreports.com. All rights reserved.

Holding

1. No, because under Internal Revenue Code Section 115(l), the distribution from Cummer Co. increased Cypress's earnings and profits since it exceeded Cypress's basis in Cummer Co.'s stock, thereby rendering the subsequent distribution to the Trust taxable.
2. Yes, because the distributions in 1943 and 1945 were supported by adequate net income in those years and thus constitute taxable dividends under Section 115(b) of the Internal Revenue Code.

Court's Reasoning

The court reasoned that while the initial distribution to Cypress might have been tax-exempt under the principle established in *Ernest E. Blauvelt* regarding pre-1913 appreciation, this exemption did not extend to the subsequent redistribution by Cypress to its shareholders. The court relied on Internal Revenue Code Section 115(l), which addresses the effect of tax-free distributions on earnings and profits. The court stated: "Unless the statute provides to the contrary, such a distribution would appear to be taxable. See *Lynch v. Hornby*, 247 U.S. 339." Since the distribution exceeded Cypress's basis in Cummer Co.'s stock, it increased Cypress's earnings and profits, making the distributions to the Trust taxable dividends.

Regarding the 1926 dividend, the court found that because Cummer Lime had sufficient earnings in 1943 and 1945, the distributions in those years were taxable as dividends, regardless of the prior declaration and the existence of "accounts payable." The court cited *Emily D. Proctor, 11 B.T.A. 235*, stating: "The dividend declared must give way to the dividend paid *in so far as the taxability of the same in the hands of the stockholders is concerned*." The court also addressed the argument that the inclusion of the unpaid dividend accounts in the gross estates of deceased stockholders should preclude the payments from being income. It noted that Congress provided a mechanism for adjusting for potential double taxation under Section 126 of the Internal Revenue Code.

Practical Implications

This case clarifies that tax-exempt characteristics of corporate distributions are not automatically preserved through successive distributions to different entities. Attorneys must consider the specific provisions of the Internal Revenue Code, particularly Section 115(l) regarding the impact of tax-free distributions on earnings and profits. The case also reinforces the principle that the taxability of dividends is determined by the company's earnings in the year the dividend is paid, not when it is declared. Furthermore, while prior estate tax inclusion of an item can affect its basis, it doesn't automatically exempt subsequent income recognition; Section 126 provides a mechanism to mitigate double taxation.

© 2025 SCOTUSreports.com. All rights reserved.