17 T.C. 781 (1951)

A dividend lawfully declared and paid constitutes taxable income to the shareholder, even if the dividend was declared based on a mistaken belief and later repaid to the corporation in the same taxable year.

Summary

The case addresses whether a dividend, declared by a personal holding corporation based on erroneous tax advice and subsequently repaid by the shareholders in the same year, constitutes taxable income. The Tax Court held that the dividend was taxable income to the shareholders, notwithstanding its repayment. The court reasoned that once a dividend is lawfully declared and paid, it becomes the property of the shareholder, and its subsequent repayment does not negate its initial character as income. The voluntary nature of the repayment, absent any legal obligation, further solidified the dividend's taxability.

Facts

Thomas Crellin Estate Company, a personal holding corporation, declared a dividend in June 1946 based on advice from a certified public accountant that distribution of capital gains was necessary to avoid personal holding company surtax. Each petitioner, as equal shareholders, received $19,998. Later in November 1946, a director discovered that the accountant's advice was incorrect and that the dividend was unnecessary. In December 1946, the board of directors rescinded the dividend declaration and demanded repayment from the shareholders, which the shareholders made before the end of the year. But for the mistaken belief about the tax consequences, the dividend would not have been declared.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax for 1946, asserting that the dividend income was taxable. The petitioners contested this determination, arguing that the dividend should not be considered income because it was declared mistakenly and repaid within the same tax year. The case was brought before the United States Tax Court.

Issue(s)

Whether a dividend received by shareholders, declared based on a mistaken belief regarding tax obligations of the corporation, and subsequently repaid to the corporation in the same taxable year, constitutes taxable income to the shareholders for that year.

Holding

No, because the dividend was lawfully declared and paid, thus becoming income to

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the shareholders. The subsequent voluntary repayment did not change the character of the initial distribution as taxable income.

Court's Reasoning

The court reasoned that a lawfully declared dividend creates a debtor-creditor relationship between the corporation and its shareholders, and once declared and announced, it cannot be rescinded by the corporation without the shareholders' consent. Referencing *United States v. Southwestern Portland Cement Co., 97 F.2d 413*, the court emphasized the general rule that "a complete and valid declaration of a dividend operates to create a debtor-creditor relationship between a corporation and its stockholders and that once a dividend is fully declared and public announcement has been made of that fact, a board of directors is powerless to rescind or revoke its action." The court distinguished the case from situations where repayments were made under new contractual agreements or where amounts were deemed excessive by mutual consent. Here, the repayment was considered voluntary and did not alter the fact that the dividend was initially received as income. The court stated, "After receipt of the dividend they were free to do with it as they saw fit, without any obligation whatever to the corporation with respect to it. That they later, during their taxable year, voluntarily returned it to the corporation in nowise detracted from the fact that they had received income".

Practical Implications

This case clarifies that the taxability of a dividend is determined at the point of distribution, assuming it's lawfully declared. Subsequent actions, such as voluntary repayment motivated by a mistake, do not retroactively negate the income. This ruling has implications for: 1) Tax planning, emphasizing the importance of accurate tax advice before declaring dividends. 2) Corporate governance, reinforcing the legal implications of dividend declarations. 3) Litigation, setting a precedent against arguing for the exclusion of dividends from income based solely on their later repayment absent a legal obligation or prior agreement. Later cases would likely distinguish Crellin where there was a binding agreement for repayment or where the dividend was improperly declared in the first instance.

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