17 T.C. 1393 (1952)

Corporate dividend distributions are conclusively presumed to be made from the most recently accumulated earnings and profits, regardless of the corporation's stated intent or designation of the distribution's source.

Summary

J. Barstow Smull, a shareholder of J.H. Winchester & Co. Inc., challenged the Commissioner's determination that cash dividends he received in 1946 were taxable income. Winchester, a personal service corporation during the war years, had undistributed Supplement S net income in 1945, which was taxed to its shareholders. In 1946, Winchester paid cash dividends, declaring them as distributions of the 1945 income. The Tax Court held that because Winchester's 1946 earnings significantly exceeded the dividend amount, the dividends were conclusively presumed to be paid from 1946 earnings under Section 115(b) of the Internal Revenue Code, thus taxable to Smull.

Facts

J. Barstow Smull was an officer, director, and stockholder of J.H. Winchester & Co. Inc. Winchester qualified as a personal service corporation from 1940-1945 and elected not to be subject to excess profits tax. In 1945, Winchester had $97,876.45 in undistributed Supplement S net income, which was taxed to its shareholders, including Smull. Winchester's 1946 net income, after taxes, was $153,406.94. In 1946, Winchester paid dividends totaling $97,696.45, declaring them as distributions of the 1945 undistributed income. Smull received $20,516.26 of these dividends.

Procedural History

The Commissioner of Internal Revenue determined a deficiency against Smull for the 1946 tax year, asserting that the dividends Smull received were taxable income. Smull challenged this determination in the Tax Court.

Issue(s)

Whether cash dividends distributed by a corporation in 1946, which the corporation declared were from 1945 undistributed Supplement S net income (already taxed to shareholders), are taxable income to the shareholders in 1946, given the corporation's 1946 earnings exceeded the dividend amount.

Holding

Yes, because Section 115(b) of the Internal Revenue Code creates a conclusive presumption that dividends are paid from the most recently accumulated earnings and profits; thus, the dividends are taxable income to the shareholders in 1946, regardless of the corporation’s declaration.

Court’s Reasoning

The Tax Court relied on Section 115(b) of the Internal Revenue Code, which states that every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. The court emphasized that this provision creates a conclusive statutory presumption. Even though Winchester declared the dividends were from 1945 income, its 1946 earnings were more than sufficient to cover the dividends. The court stated, “the expression of the directors as to the source of corporate dividends must be disregarded” when the corporation had sufficient earnings in the year of distribution. The court found no exception to Section 115(b) for distributions claimed to be from undistributed Supplement S net income. They stated that sections 394(d) and (e) are consistent with 115(b).

Practical Implications

This case reinforces the strict application of Section 115(b) in determining the source of dividend distributions. It establishes that a corporation’s intent or declaration regarding the source of dividends is irrelevant if the corporation has sufficient earnings in the year of distribution. Attorneys must advise clients that tax planning based on directing dividend distributions from specific sources within a corporation is unlikely to succeed where current-year earnings are adequate. This decision impacts how corporations manage dividend distributions and how shareholders report dividend income, as it prioritizes the statutory presumption over corporate intent. Later cases applying this ruling would likely follow this precedent, especially regarding closely held corporations, in cases where an attempt is made to manipulate dividend income for tax advantage.