19 T.C. 1082 (1953)

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A corporate distribution of appreciated property is taxable as a dividend to the shareholders only to the extent of the corporation’s earnings and profits, and the unrealized appreciation does not increase the corporation’s earnings and profits for dividend taxation purposes.

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Summary

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Southern Natural Gas Company distributed cash and stock of its subsidiary, Southern Production Company, to its shareholders. The stock had a fair market value significantly higher than its cost basis. The Tax Court addressed whether the distribution should be taxed to the shareholders based on the fair market value or the cost basis, and whether the appreciation in value increased Southern Natural Gas Company’s earnings and profits. The court held that the distribution was taxable as a dividend only to the extent of Southern Natural Gas Company’s earnings and profits, and the appreciation did not increase those earnings and profits. The excess of the fair market value over earnings and profits reduced the basis of the shareholder’s stock.

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Facts

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Ida S. Godley owned 200 shares of Southern Natural Gas Company (Southern) stock. In 1947, Southern distributed cash and stock in Southern Production Company to its shareholders, including Godley. The distributed stock had a fair market value of $6.375 per share, while Southern’s adjusted basis was lower. Southern’s total earnings and profits available for dividends was $5,674,586.32. Southern distributed $2,113,722.03 in cash and Southern Production Company stock with a cost basis of $3,199,950 and a fair market value of $8,983,407.75. The IRS determined that the distributions to the stockholders were 100% taxable.

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Procedural History

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The Commissioner of Internal Revenue determined a deficiency in Godley's income tax for 1947. Godley's estate petitioned the Tax Court for review. The Tax Court considered the taxability of the corporate distributions.

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Issue(s)

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Whether corporate distributions in cash and property are taxable to a stockholder in full, or only to the extent that the fair market value of the distributions is covered by earnings and profits, with the balance being applied to reduce the basis at which the decedent held her stock.

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Holding

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No, the distributions are taxable as dividends only to the extent of earnings and profits available for dividends because the appreciation in value of the distributed property does not serve to increase the corporation's earnings or profits.

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Court's Reasoning

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The court relied on the principle established in *General Utilities & Operating Co. v. Helvering*, that appreciation in value over cost or adjusted basis of property distributed as a dividend in kind does not constitute a realization of income to the distributing corporation. The court reasoned that taxing the distribution based on fair market value without regard to earnings and profits would allow the IRS to indirectly accomplish what *General Utilities* prevented directly: writing up the earnings or profits of the distributing corporation by the amount of unrealized appreciation in the property distributed. The court stated that "the fair market value of the distributed property is taxable as a dividend to the extent of the earnings or

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profits (without increase as a result of appreciation in value over cost of the property distributed) of the distributing corporation." To the extent the fair market value exceeded the corporation's earnings and profits, the excess was applied to reduce the basis of the shareholder's stock.

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Practical Implications

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This case clarifies the tax treatment of corporate distributions of appreciated property. It confirms that shareholders are only taxed on dividends to the extent of the corporation's earnings and profits. The decision prevents the IRS from taxing unrealized appreciation at the corporate level by increasing earnings and profits. Attorneys advising corporations on dividend distributions need to understand this limitation to properly advise clients on the tax consequences of in-kind distributions. This case limits the IRS's ability to characterize distributions as

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