20 T.C. 20 (1953)

When a corporation sells assets to its shareholders at a bargain price, the difference between the asset's cost, its fair market value, and the sale price affects the computation of the corporation's earnings and profits available for dividend distribution.

Summary

W.G. Maguire & Co. challenged the Commissioner's deficiency determination regarding income from stock rights and dividend income. The central issue was whether distributions by Missouri-Kansas Pipe Line Co. (Mokan) to its shareholders were taxable dividends. Mokan had sold Panhandle Eastern stock to its shareholders at a discount. The Tax Court held that the distributions were a return of capital, not dividends, because Mokan's earnings and profits were insufficient after accounting for losses on the sale of the Panhandle Eastern stock. The court also addressed the tax basis for sold stock rights, finding that the petitioners were entitled to a cost basis.

Facts

Mokan distributed cash and rights to purchase Panhandle Eastern stock to its shareholders. The rights allowed shareholders to buy Panhandle Eastern shares at $30 when the market value was $40. Mokan had acquired Panhandle Eastern stock at an average cost of $47.86 per share. Petitioners, stockholders in Mokan, received these distributions. W.G. Maguire & Co. and William Maguire sold their rights; Marian Maguire exercised hers. The Commissioner determined that a portion of the cash distributions constituted taxable dividends and disallowed the petitioners' calculation of capital gains from the sale of stock rights.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against the petitioners for the 1944 tax year. The petitioners challenged these deficiencies in the Tax Court, arguing that the distributions were not taxable dividends and that the Commissioner had erred in calculating the gains from the sale of stock rights. The cases were consolidated due to the common issues.

Issue(s)

1. What was the proper tax basis for the Panhandle Eastern stock sold by Mokan?

2. Were the cash distributions by Mokan to its shareholders taxable as dividends?

3. Did income result from Marian L. Maguire's exercise of rights to purchase Panhandle Eastern stock, and if so, how should it be taxed?

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4. How should gains from the sale of stock rights by W.G. Maguire & Co. and William Maguire be calculated and taxed?

Holding

1. The proper tax basis for the Panhandle Eastern stock sold by Mokan was $47.86 per share because petitioners' evidence identified the shares of stock in question.

2. No, the cash distributions by Mokan were not taxable dividends because Mokan had no earnings or profits available for distribution after accounting for losses sustained on the sale of Panhandle Eastern shares.

3. No, income did not result from Marian L. Maguire's exercise of the stock purchase rights because Mokan had no earnings or profits available for distribution as dividends.

4. The petitioners were entitled to a cost basis of $1 per right when calculating gains from the sale of their stock rights, and the Commissioner erred by treating the entire proceeds as ordinary income.

Court's Reasoning

The court reasoned that Mokan's sale of Panhandle Eastern stock to its shareholders at a discount consisted of both a sale and a distribution. The difference between Mokan's cost ($47.86) and the fair market value ($40) was treated as a loss. The court deducted that $7.86 loss per share from Mokan's earnings to determine the earnings and profits available for dividends. The additional $10 discount given to shareholders (difference between fair market value and the $30 sale price) was deemed a distribution of capital and not deductible from current earnings and profits. Because the loss reduced Mokan's earnings and profits below zero, the distributions were considered a return of capital under Section 115(d) of the Code, not taxable dividends. Regarding the stock rights, the court determined a cost basis of $1 per right based on the distribution of capital when the rights were issued.

Practical Implications

This case provides guidance on determining a corporation's earnings and profits, particularly when assets are distributed to shareholders at below-market prices. It clarifies that losses on such sales can reduce earnings and profits available for dividends. It reinforces the principle that distributions of capital are not taxable as dividends but reduce the shareholder's basis in their stock. The decision highlights the importance of distinguishing between a

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