*20 T.C. 318 (1953)*

Distributions from a corporation's earnings are taxable as ordinary income, and the reporting of an item with a statement that it's not taxable does not prevent it from being considered omitted income for the extended statute of limitations.

**Summary**

Peyton and Anna Nevitt received $3,802.50 in 1946 as accumulated dividends on preferred stock under a recapitalization plan but didn't include it as income on their tax return, claiming it was a return of capital. The IRS assessed a deficiency, arguing it was taxable dividend income and that the 5-year statute of limitations applied due to the omission of income. The Tax Court agreed with the IRS, holding that the distribution was taxable as a dividend and that reporting the amount with a claim of non-taxability constituted an omission of income, triggering the extended statute of limitations.

**Facts**

The Nevitts owned 65 shares of American Woolen Company's 7% cumulative preferred stock. In 1946, American Woolen implemented a Plan of Recapitalization, offering shareholders the option to exchange their preferred stock for new stock and cash, or to receive cash for accumulated dividends. The Nevitts chose to receive $3,802.50 in cash for their accumulated dividends. On their 1946 tax return, they reported receiving the $3,802.50 but stated it was a "distribution of capital" and "not listed for income tax purposes." American Woolen had sufficient earnings and profits to cover the distribution as a dividend.

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in the Nevitts' 1946 income tax. The IRS argued the $3,802.50 was taxable as dividend income and that the 5-year statute of limitations applied because the Nevitts omitted over 25% of their gross income. The Nevitts contested the deficiency, arguing the distribution was a return of capital, and that the 3-year statute of limitations should apply because they disclosed the receipt of the funds on their return.

**Issue(s)**

1. Whether the $3,802.50 received by the Nevitts from American Woolen Company in 1946 constituted taxable dividend income.

2. Whether the Nevitts' reporting of the $3,802.50 on an enclosure to their return, with the statement that it was not taxable, constituted an omission of income for purposes of the 5-year statute of limitations under Section 275(c) of the Internal Revenue Code.

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## Holding

1. Yes, because the American Woolen Company had sufficient earnings and profits to cover the distribution, making it a taxable dividend under Section 115(a) of the Internal Revenue Code.

2. Yes, because failing to report the amount as income, despite disclosing its receipt with a claim of non-taxability, is considered an omission from gross income, triggering the extended statute of limitations.

## Court's Reasoning

The court relied on Section 115(a) of the Internal Revenue Code, which defines a dividend as "any distribution made by a corporation to its shareholders… out of its earnings or profits." Since American Woolen had ample earnings and profits, the distribution to the Nevitts fell within this definition and was taxable as ordinary income. The court cited *Bazley v. Commissioner, 331 U.S. 737*, to reinforce the principle that distributions from earnings and profits are taxable dividends. Regarding the statute of limitations, the court followed *Estate of C. P. Hale, 1 T.C. 121*, which held that reporting an item as a capital receipt, rather than as income, effectively omits it from gross income, even if the item is disclosed elsewhere on the return. The court quoted *Estate of C.P. Hale* stating, "Failure to report it as income received was an omission resulting in an understatement of gross income in the return. The effect of such designation and failure to report as income was in substance the same as though the items had not been set forth in the return at all." This omission triggered the 5-year statute of limitations because the omitted amount exceeded 25% of the gross income reported on the return.

## Practical Implications

This case clarifies that simply disclosing the receipt of funds is not sufficient to avoid the extended statute of limitations for omissions of income. Taxpayers must properly characterize and report items as income to avoid the extended period for assessment. The case also underscores the importance of accurately determining whether corporate distributions qualify as dividends, based on the corporation's earnings and profits. It reinforces the IRS's ability to challenge the characterization of income items, even if disclosed, where the taxpayer's treatment is inconsistent with established tax principles. The ruling impacts how tax professionals advise clients on disclosure requirements and the potential for extended audit periods when items are reported with a claim of non-taxability. This case has been cited in subsequent tax court cases regarding the interpretation and application of Section 275(c).

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