23 T.C. 756 (1955)

Corporate distributions to shareholders that are not dividends (i.e., not from current or accumulated earnings and profits) are applied against the stock's adjusted basis; amounts exceeding the basis are taxed as capital gains if the stock has been held for the required period.

Summary

The case involved the tax treatment of cash distributions made by several corporations to their shareholders. The distributions exceeded the corporations' earnings and profits, originating from sources such as mortgage proceeds and depreciation reserves. The primary issue was whether the distributions should be taxed as ordinary income or as capital gains. The Tax Court held that, under Section 115(d) of the Internal Revenue Code of 1939, the distributions should first reduce the stockholders' basis in their stock, and any excess was taxable as long-term capital gain. The court reasoned that since the distributions were not dividends (as defined by the code) and not liquidating distributions, they fell under the capital gains provision.

Facts

George M. Gross and related individuals were stockholders in several corporations involved in real estate development, particularly apartment complexes. These corporations received mortgage financing insured by the Federal Housing Administration (FHA). The actual construction costs were lower than the mortgage amounts received. The corporations distributed cash to stockholders in 1948 and 1949 from the excess mortgage proceeds, premiums on mortgage bonds, gross rents, and depreciation reserves. The corporations had written up the value of their real estate on their books. The stockholders had held their stock for more than six months prior to the distributions. The Commissioner argued the distributions were ordinary income; the taxpayers argued for capital gains treatment under IRC § 115(d).

Procedural History

The Commissioner of Internal Revenue determined tax deficiencies against the stockholders, asserting that the distributions were taxable as ordinary income. The stockholders petitioned the United States Tax Court, challenging the Commissioner's determination. The Tax Court consolidated the cases and found in favor of the petitioners, concluding that the distributions were taxable as capital gains to the extent they exceeded the adjusted basis of the stock, as prescribed by I.R.C. § 115(d).

Issue(s)

1. Whether the distributions made by the corporations to their shareholders are

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taxable as ordinary income or capital gains.
2. Whether, for purposes of taxation, distributions from depreciation reserves are considered distributions of capital and not income.
3. Whether the distributions made to the officer-stockholders are, in any part, salaries for their services.

Holding

1. Yes, because the distributions exceeded the corporations' earnings and profits, they were properly treated as a return of capital to the extent of the adjusted basis of the stock, and any excess was taxed as capital gains under I.R.C. § 115(d).
2. Yes, distributions from depreciation reserves are distributions of capital.
3. No, because there was no existing obligation of law or contract to pay salaries.

Court's Reasoning

The court analyzed the case under § 115 of the 1939 Internal Revenue Code, which determined the tax consequences of distributions to stockholders. The Court reasoned that the distributions, exceeding earnings and profits, were not dividends. The Court found the distributions were from sources other than earnings and profits, like the mortgage proceeds or depreciation reserves. The court referenced the legislative history of § 115(d), which provided that any distribution not out of earnings or profits would first reduce the basis of the stock and be taxed as a capital gain. The court distinguished this case from cases involving distributions of appreciated property, where the fair market value was relevant. In the case of distributions from depreciation reserves, the court referred to the regulations specifying that such distributions would be from capital. Furthermore, because there was no agreement in place, nor any evidence to suggest an obligation of law to pay salaries, the Court found the distributions were not salary.

Practical Implications

This case provides a practical framework for determining the tax treatment of corporate distributions that exceed current and accumulated earnings and profits. It emphasizes the importance of the source of the distribution; distributions from depreciation reserves, for example, can be treated as capital. It underlines that if a distribution is not a dividend, it is subject to the rules outlined in I.R.C. § 115(d). This case is relevant when advising shareholders of closely held corporations on the tax implications of distributions that are not funded by current or accumulated earnings and profits. Moreover, the case confirms that when taxpayers arrange their affairs to reduce their taxes, the tax consequences follow from what they did, not what they might have done. The 1954 Internal Revenue Code would later address some of the concerns raised in this case.

Meta Description

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The case clarifies how corporate distributions exceeding earnings and profits are taxed. It provides guidance on applying the stock basis and capital gains rules, particularly distributions from depreciation reserves.

Tags

Gross v. Commissioner, Tax Court, 1955, Corporate Distributions, Capital Gains, Depreciation Reserves, Section 115(d)

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