23 T.C. 1105 (1955)

Funds diverted from a corporation by its controlling shareholders are taxable as income to the corporation, and as dividends to the shareholders to the extent of the corporation's earnings and profits. Also, accrued but unpaid federal taxes are not deductible in determining earnings and profits.

Summary

In this case, the United States Tax Court addressed several tax issues related to a corporation and its controlling shareholders. The court determined that funds taken from the corporation's incoming mail by its principal shareholders, who then cashed the checks and divided the proceeds, were taxable as income to the corporation and as constructive dividends to the shareholders. The court rejected the corporation's claim of an embezzlement loss, finding the shareholders' actions were not an embezzlement of funds for tax purposes. Furthermore, the court held that accrued but unpaid federal taxes were not deductible in determining the earnings and profits of a cash basis corporation. The court also upheld fraud penalties against both the corporation and the individual shareholders due to their attempts to evade taxes. Finally, the court clarified the proper method for accounting for profits on claims purchased from insolvent banks and denied a deduction for real estate taxes where payment was made by cashier's check but not remitted to the taxing authority in the relevant tax year.

Facts

United Mercantile Agencies, Inc. (United), a Kentucky corporation, was run by Drybrough and Simpson who owned or controlled all of the outstanding stock. During the tax years in question, Drybrough and Simpson removed checks from the corporation's incoming mail, cashed them, and divided the proceeds in proportion to their stock ownership. These transactions were not reflected in the corporate records. The funds represented payments on claims the corporation had purchased and fees for collections. Drybrough and Simpson were later indicted and pleaded nolo contendere to charges of tax evasion. The corporation also purchased claims from insolvent banks and used a method of accounting where no profit was realized until the cost of the claims was recovered. In a separate transaction, United purchased cashier's checks for real estate taxes, but the checks were not delivered to the tax authorities until a later year.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the tax of United, Drybrough, and Simpson, and imposed additions to tax for fraud. The petitioners challenged these determinations in the United States Tax Court. The cases were consolidated for hearing and opinion.

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Issue(s)

1. Whether the funds diverted by the shareholders constituted income to the corporation, and if so, whether the corporation was entitled to an embezzlement loss deduction.

2. Whether the diverted funds were taxable as dividends to the officer-stockholders.

3. Whether a cash-basis corporation could deduct accrued but unpaid federal taxes when calculating earnings and profits.

4. Whether the corporation and the individual petitioners were liable for fraud penalties.

5. Whether the statute of limitations barred any of the assessed deficiencies.

6. Whether the Commissioner was correct in increasing the corporation's taxable income by requiring the cost recovery method for assets purchased from insolvent banks.

7. Whether the corporation was entitled to a deduction for real estate taxes paid via cashier's checks that were not remitted to the tax authorities in the relevant year.

Holding

1. Yes, the diverted funds were income to the corporation, and no, the corporation was not entitled to an offsetting embezzlement loss.

2. Yes, the diverted funds were taxable as dividends to the officer-stockholders, except for the portion received by Drybrough for his wife's stock.

3. No.

4. Yes.

5. No.

6. Yes.

7. No.

Court's Reasoning

The court reasoned that because Drybrough and Simpson owned or controlled all of the stock, the diversion of funds represented distributions of corporate income. The court cited precedent that established that diverted funds are taxable to the corporation and constitute dividends to the shareholder-officers. The court found that the wife's lack of knowledge of the withdrawals did not change the nature of the

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distributions, considering that Drybrough managed all of her business affairs and that their actions were not considered as embezzlement. “Practically speaking the transactions represented the receipt of checks by the corporation… the endorsement and cashing of the checks by the corporation’s principal officers, and the distribution of the money to the stockholders in proportion to their stock holdings.” The court held that the corporation could not claim an embezzlement loss because the shareholders were acting for the corporation and not stealing from it. Accrued but unpaid federal taxes were not deductible in determining earnings and profits, following prior case law. The court found clear and convincing evidence of fraud, as the individual petitioners knew the funds were taxable and intended to evade taxes, therefore the penalties were upheld. Regarding the insolvent banks, the court agreed that United properly used a cost recovery method and also upheld the IRS’s denial of the tax deduction related to the cashier’s checks, as payment hadn’t been made.

Practical Implications

This case is critical for understanding how the IRS and the courts will treat the diversion of corporate funds. The ruling reinforces that the tax consequences follow the economic reality of transactions. The case serves as a warning to corporate officers who might consider diverting corporate funds to their personal use, and it establishes the importance of proper accounting methods. The decision emphasizes that the courts are willing to “pierce the corporate veil” to determine the actual nature of the financial transactions for tax purposes. This case provides guidelines on how the IRS may handle similar situations, as well as how a corporation’s tax liability and shareholders’ tax liabilities are interlinked. The case also clarifies the definition of “payment” for tax purposes, specifically in regards to the use of cashier’s checks and how that applies to the timing of deductions.

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