Richards v. Commissioner, 27 T.C. 1071 (1957)

When a corporation distributes funds to shareholders and lacks earnings and profits, the distribution reduces the shareholders' basis in the stock, and any excess is taxed as capital gain; further, the Commissioner bears the burden of proof when raising a new legal theory in a tax deficiency case.

Summary

The case involved a dispute over how distributions from a corporation with no accumulated earnings and profits should be taxed. The Commissioner argued the distributions were ordinary income, while the taxpayers claimed capital gains treatment. The Tax Court sided with the taxpayers, holding that the distributions reduced the stock basis and any excess was capital gain. Furthermore, the Court addressed an issue regarding the burden of proof; since the Commissioner raised a new legal theory for deficiency after issuing the initial notice, the Commissioner bore the burden of proof related to that theory.

Facts

The case involved distributions in partial redemption of stock made by Brookwood, Inc., which had no accumulated earnings and profits. The taxpayers reported these distributions as long-term capital gains. The Commissioner initially determined that the distributions constituted ordinary income, basing his position on sections 22(a) and 115(a) of the Internal Revenue Code of 1939. Later, in the hearing, the Commissioner indicated that he was also relying on section 117(m) of the Internal Revenue Code of 1939, which deals with "collapsible corporations."

Procedural History

The case originated in the Tax Court. The Commissioner assessed tax deficiencies against the taxpayers. The Tax Court reviewed the Commissioner's determinations, considering the arguments from both sides regarding the appropriate tax treatment of the corporate distributions. Ultimately, the Tax Court ruled in favor of the taxpayers on the primary issue of the character of the distributions and further clarified who held the burden of proof regarding additional claims made by the IRS.

Issue(s)

1. Whether distributions made by Brookwood, Inc., without accumulated earnings and profits, should be treated as ordinary income or capital gains.

2. Whether the Commissioner had the burden of proof regarding the application of section 117(m) of the Internal Revenue Code of 1939 after raising it for the first time at the hearing.

Holding

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1. No, because, the Tax Court held that the distributions reduced the basis of the stock, and any excess was taxable as long-term capital gains.

2. Yes, because the Commissioner introduced section 117(m) as a new basis for the deficiency determination after issuing the initial notice of deficiency, therefore shifting the burden of proof to the Commissioner.

Court's Reasoning

The court relied on the precedent established in *George M. Gross*, where it rejected the Commissioner's argument that distributions from corporations without earnings and profits should be taxed as ordinary income. Instead, the Tax Court reaffirmed that such distributions should first reduce the shareholder's basis in the stock. Any amount exceeding the basis is then taxed as capital gain. The Court cited Section 115(d) of the 1939 Code to support this conclusion.

The Court then addressed the issue of burden of proof. The Court found that since the Commissioner had raised section 117(m), related to collapsible corporations, as a new basis for the deficiency at the hearing, the burden of proving its applicability shifted to the Commissioner. The Court cited *Sheldon Tauber* for the precedent of a departure from the initial grounds used in a deficiency notice. Since the Commissioner did not meet his burden of proving that over 70% of the gain was attributable to the constructed property as required under section 117(m), the Court ruled in favor of the taxpayers.

The court also noted that the Commissioner's argument, that a distribution must impair capital to be considered

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