Wilson v. Commissioner, 25 T.C. 1058 (1956)

When a corporation distributes funds in redemption of its stock, and the corporation has no earnings and profits, the distribution is applied against the shareholder's basis in the stock, and any excess is taxed as long-term capital gain under section 115(d) of the 1939 Code.

Summary

In this case, the U.S. Tax Court addressed whether distributions from a corporation to its shareholders should be taxed as capital gains or ordinary income. The Wilsons and the Richards formed corporations to build housing projects. The corporations then redeemed shares from the shareholders. The Commissioner of Internal Revenue determined these distributions were ordinary income. The Tax Court held that because the corporations lacked earnings and profits, the distributions were a return of capital, taxed as capital gains to the extent they exceeded the shareholders' basis in the stock. The court also determined that the Commissioner bore the burden of proof when raising new arguments (specifically, section 117(m) of the Internal Revenue Code) not initially presented in the deficiency notice.

Facts

Thomas and Mary Wilson, along with Edward and Helene Richards, were engaged in the contracting and construction business. They formed a corporation, Brookwood, Inc., to build houses. Brookwood issued both common and preferred stock. Brookwood had no earnings and profits at the time of the stock redemption in 1948. In 1948, Brookwood redeemed some of its preferred stock, and later a portion of its common stock, from Wilson and Richards. Funds for these redemptions came from multiple sources including borrowed funds. Later, Richards and Wilson had similar transactions with other corporations, Greenway Apartments, Inc. and Washington Terrace Apartments, Inc.. The Commissioner of Internal Revenue determined that the distributions received by the shareholders from the stock redemptions were taxable as ordinary income, not capital gains. The Wilsons and Richards challenged this determination.

Procedural History

The Commissioner of Internal Revenue issued notices of deficiency to the Wilsons and the Richards, claiming the distributions were ordinary income. The Wilsons and Richards petitioned the U.S. Tax Court, arguing that the distributions should be taxed as capital gains. The Commissioner also raised Section 117(m) of the Internal Revenue Code, claiming the corporations were collapsible. The Tax Court consolidated the cases, and ultimately ruled in favor of the taxpayers.

Issue(s)

1. Whether the distributions from Brookwood, Greenway, and Washington Terrace

to the petitioners in redemption of their stock were taxable as capital gains or ordinary income.

2. Whether the statute of limitations barred the assessment of a deficiency against Edward N. and Helene H. Richards for 1948.

3. Whether the Commissioner, having initially relied on Section 22(a) of the Internal Revenue Code, and later relying on section 117(m), bore the burden of proof regarding the applicability of section 117(m).

Holding

1. Yes, the distributions were taxable as capital gains because the corporations had no earnings and profits, and distributions should be applied against the shareholders' basis in their stock.

2. Yes, the statute of limitations barred the assessment for 1948.

3. Yes, the Commissioner bore the burden of proof.

Court's Reasoning

The court focused on the application of the 1939 Internal Revenue Code to the facts. Specifically, the court considered whether section 115(d) applied. The court determined that the distributions were not out of earnings and profits, and therefore, the distributions reduced the basis of the stock. When the distributions exceeded basis, they were taxed as capital gains. The court referenced *George M. Gross*, where the court previously rejected the IRS's interpretation of the 1939 code. The court applied the principles set forth in *George M. Gross*.

As the court stated, "We adhere to our recent decision in *George M. Gross, supra*, and for the reasons set forth therein, we must reject respondent's position. Accordingly, we hold that, as the corporation had no earnings and profits, the distributions must be applied against and reduce petitioners' bases in the stock, and to the extent that the distributions exceed those bases, such excess is taxable as long-term capital gain."

The court also addressed whether the Commissioner could raise a new argument at the hearing that the gains realized by petitioners were taxable under section 117(m) (collapsible corporation). The court stated, "While a statutory notice of deficiency is presumed correct, and a petitioner has the burden of disproving its correctness, when the Commissioner departs from the grounds relied on in his deficiency notice to sustain a theory later raised, he has the burden of proving any new matter raised." Since the Commissioner raised section 117(m) late, the Commissioner had the burden of proof. The court found that the Commissioner failed to prove that more than 70 percent of the gain was attributable to the property constructed, as required by the statute. Therefore, the court held that the Commissioner had not met his burden of proof on the 117(m) question.

Practical Implications

This case is important for several reasons: 1) It reinforces the principle that when corporations without earnings and profits distribute funds in redemption of stock, the distributions are treated as a return of capital. This can lead to a significant tax advantage when the distributions can be treated as capital gains rather than ordinary income. 2) The case clarifies that taxpayers should carefully examine the source of corporate distributions and how they interact with the shareholder's basis in the stock. 3) It highlights the importance of the government providing proper notice when determining a tax deficiency. When the IRS raises new arguments, the burden of proof shifts to the government. This shifts the advantage to the taxpayer in challenging the IRS.

This case has implications for tax planning regarding corporate distributions, redemptions, and the timing and basis of stock transactions. The court's emphasis on the source of funds for corporate distributions, the application of section 115, and the burden of proof should guide similar tax cases.

