26 T.C. 306 (1956)

When a corporation transfers its assets to a new corporation controlled by the same shareholders, and distributes cash and other assets to those shareholders as part of a reorganization plan, those distributions may be treated as taxable dividends, even if the overall transaction resembles a liquidation.

Summary

In this case, the Tax Court addressed whether distributions received by a sole shareholder were taxable as liquidating distributions or as dividends under a corporate reorganization. The shareholder, Ethel K. Lesser, controlled Capital Investment and Guarantee Company, which owned apartment buildings. Lesser decided to split the properties into two new corporations, Blair Apartment Corporation and Earlington Investment Corporation. Capital transferred its assets to the new corporations, and distributed cash and notes to Lesser. The court held that the transactions constituted a reorganization and the distributions to Lesser had the effect of a taxable dividend, considering that Capital had significant undistributed earnings.

Facts

Ethel K. Lesser, along with a testamentary trust, received shares in Capital Investment and Guarantee Company (Capital) and Metropolitan Investment Company. Lesser and the trust later acquired 297 shares of Capital stock in exchange for 48 shares of Metropolitan stock and cash, becoming the sole stockholders of Capital. Lesser decided to separate Capital's properties, Blair Apartments, Earlington Apartments and Le Marquis Apartments, into two separate corporations to facilitate future disposition of Blair Apartments. She organized Blair Apartment Corporation (Blair) and Earlington Investment Corporation (Earlington). Capital was dissolved, transferring the Earlington and Le Marquis apartment buildings to Earlington and the Blair apartment building to Blair. Capital distributed cash and notes to Lesser and the trust. After these transfers, Capital ceased operations.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Lesser's and the estate's income tax for 1950, arguing that the distributions should be taxed as dividends. The Tax Court consolidated the cases and addressed the issues of whether the distributions were properly treated as liquidation distributions or as distributions pursuant to a reorganization, and whether the distributions were taxable as ordinary dividends. The Tax Court sided with the Commissioner.

Issue(s)

1. Whether the corporate distributions to the shareholders were taxable as

distributions in liquidation or as distributions made pursuant to a reorganization, and thus taxable as a dividend?

2. If the distributions were part of a reorganization, whether the distributions are taxable as ordinary dividends?

Holding

1. Yes, the distributions were made pursuant to a reorganization and are taxable as dividends because the transactions, viewed as a whole, constituted a reorganization under Section 112(g)(1)(D) of the 1939 Internal Revenue Code.

2. The court did not address whether the distributions were taxable as ordinary dividends under section 115(g) of the 1939 Code, because it held the distributions were taxable dividends pursuant to section 112(c)(2) of the 1939 Code.

Court's Reasoning

The court determined that the series of transactions, including the transfer of assets to newly formed corporations and the distribution of cash and notes, constituted a reorganization under Section 112(g)(1)(D) of the 1939 Internal Revenue Code. The court focused on the substance of the transactions, examining them as a whole to discern a reorganization plan. It emphasized that the shareholders of the original corporation controlled both the transferor and transferee corporations, satisfying the control requirement for a reorganization. The court held that the distribution of cash and notes, as part of the reorganization, had the effect of a taxable dividend, especially considering the history of accumulated earnings and profits of the original corporation and the lack of prior dividend payments. The court cited precedent and determined it was proper to consider all transactions together rather than separately.

Practical Implications

This case clarifies that the form of a transaction does not control its tax consequences; the substance of a transaction, viewed in its entirety, is determinative. A corporate reorganization under the tax code can occur even where there is no formal written plan or direct transfer of assets from the old corporation to the new corporation, especially when the same shareholders control both entities. Distributions made as part of a reorganization can be taxed as dividends if they have that effect, even if the transactions also resemble a corporate liquidation. This case informs how to structure corporate transactions and emphasizes the importance of considering the tax implications of reorganizations involving distributions to shareholders, and in general, underscores the potential tax consequences that can arise when cash or other assets are distributed as part of a corporate restructuring. It also suggests that if a corporation has significant earnings and profits, distributions to shareholders as part of a reorganization are more likely to be treated as taxable dividends.

