33 T.C. 19 (1959)

A corporate distribution is taxable as a dividend to the extent it is made out of earnings or profits, and such a distribution exhausts the corporation's available earnings and profits even if it's followed by a contribution to capital surplus by a parent company.

Summary

The case involves the tax treatment of a distribution received by the petitioners on preferred stock. The issue was whether the distribution was a taxable dividend. The Tax Court determined that a prior distribution by the corporation to its common stockholders, funded with its accumulated earnings and profits, constituted a taxable dividend. This earlier distribution exhausted the corporation's earnings and profits. Therefore, the later distribution to the petitioners could not be considered a dividend, as it was made when no earnings or profits remained. The court disregarded a subsequent contribution to capital surplus by the parent company of the corporation. The court emphasized that the taxability of corporate distributions is determined by federal statutes.

Facts

Carl and Ruth Lundeen (petitioners) received a distribution on their preferred stock in 1953 from the Northern Transit Company (Transit). In 1946, Transit declared a dividend of $400 per share on its common stock, totaling $100,000, which was paid out of its accumulated earnings and profits of $89,647.24. Northwest Motor Service Company (Motor Service), which owned 94% of Transit's common stock, received $94,000 of that dividend. Two days later, Motor Service resolved to contribute $100,000 to Transit's capital surplus. The IRS contended the 1953 distribution to petitioners was taxable; the petitioners argued it was not, as Transit had no remaining earnings or profits because of the 1946 distribution.

Procedural History

The Commissioner of Internal Revenue determined a tax deficiency against the Lundeen's for 1953, claiming the distribution was a taxable dividend. The Lundeen's challenged this determination in the United States Tax Court.

Issue(s)

1. Whether the 1946 distribution to the common stockholders of Northern Transit Company constituted a taxable dividend that exhausted the company's earnings and profits.

2. Whether the subsequent contribution to capital surplus by Motor Service affected the taxability of the 1953 distribution to the petitioners.

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Holding

1. Yes, the 1946 distribution to common stockholders was a taxable dividend because it was paid from accumulated earnings and profits.

2. No, the subsequent contribution to capital surplus did not alter the taxability of the 1953 distribution.

Court’s Reasoning

The court found that under the Internal Revenue Code of 1939, section 115(a), a taxable dividend is any distribution made by a corporation to its shareholders out of accumulated earnings or profits. Transit had accumulated earnings and profits at the time of the 1946 distribution. The court emphasized that the federal statute, not state law, governed the taxability of corporate distributions. The court found no basis for disregarding the 1946 dividend because it met the requirements to be treated as a taxable distribution. The court also noted the lack of a clear intent to rescind the dividend. Although the court acknowledged a manipulative setup where one company paid a dividend and the other “repaid” the funds through a capital contribution, the court still found the dividend, which was paid from actual profits, to be fully valid. The contribution to surplus did not change the fact that the 1946 dividend exhausted the company’s earnings and profits.

Practical Implications

This case reinforces the principle that distributions from accumulated earnings and profits are taxable dividends, and once distributed, those earnings are no longer available. The order of transactions matters. Even though the payment and “repayment” were closely linked, the 1946 distribution was a taxable event. The court will look beyond form to the substance, however it applied a strict interpretation of the tax code in this case. This case highlights that when planning corporate transactions, legal practitioners must carefully consider the tax implications of distributions and the timing of related financial maneuvers. The case underscores that a distribution legally made will exhaust a corporation’s earnings and profits, and subsequent capital contributions will not retroactively change the taxability of a prior distribution. Later cases might cite this case for its stance on the priority of federal law.

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