***S.M. Friedman v. Commissioner*, 23 T.C. 410 (1954)**

The taxability of corporate distributions as dividends is determined under federal law, without regard to state law, unless there is a declared or plainly indicated purpose or intent that state law is to be taken into account.

Summary

The case concerns the tax treatment of a corporate distribution. Transit, a corporation, declared and paid a dividend to its common stockholders. Two days later, Motor Service, which owned the majority of Transit's common stock, contributed to Transit's capital surplus an amount equal to the dividend paid. The Commissioner argued that this was a manipulation, and the dividend should not be considered taxable. The Tax Court held that the initial distribution was a taxable dividend under federal law, as the company had sufficient accumulated earnings and profits, and the subsequent capital contribution did not negate the tax consequences of the initial distribution.

Facts

- Transit declared a dividend of $400 per share on its common stock on December 28, 1946.
- Motor Service owned 94% of Transit's common stock.
- Two days later, Motor Service contributed $100,000 to Transit's capital surplus.
- Transit had accumulated earnings and profits of $89,641.24 on the dividend declaration date.
- Motor Service subsequently offset a portion of the contribution with amounts owed by Transit for rentals.
- The IRS determined the $600 received by the petitioners in 1953 on their preferred stock was a taxable dividend, and contended the 1946 payment was not a taxable dividend.

Procedural History

The case was heard by the United States Tax Court, which ruled on the taxability of the dividend payments.

Issue(s)

1. Whether the $100,000 distribution by Transit to its common stockholders on December 28, 1946, constituted a taxable dividend despite the subsequent contribution to capital surplus.

Holding

1. Yes, the $100,000 distribution was a taxable dividend because Transit had

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accumulated earnings or profits at the time of the distribution.

Court’s Reasoning

The court applied federal tax law to determine the taxability of the dividend, specifically section 115(a) and (b) of the Internal Revenue Code of 1939, defining taxable dividends as distributions from accumulated earnings and profits. The court found that Transit had sufficient earnings and profits to cover the distribution. The court stated that the intent of the state law was not clear and thus not relevant to the determination of the taxable dividend. The court emphasized that “in the absence of a declared or plainly indicated purpose or intent that State law is to be taken into account, as was the case in United States v. Ogilvie Hardware Co., 330 U.S. 709, the taxability of corporate distributions is to be determined according to the Federal statute.” The court focused on the actual distribution of funds and the presence of accumulated earnings, rather than the subsequent actions of Motor Service. The court noted the two-day gap between the dividend payment and the subsequent capital contribution and deemed there was no rescission of the initial dividend.

Practical Implications

This case underscores the importance of federal tax law in determining the taxability of corporate distributions. It clarifies that a distribution of earnings and profits constitutes a taxable dividend regardless of subsequent transactions, such as capital contributions by shareholders, unless the intent to invoke state law to the contrary is clearly demonstrated. Practitioners should carefully analyze the corporation’s earnings and profits and the actual distributions made to shareholders, focusing on federal law provisions. Subsequent events, such as repayments or contributions, do not necessarily alter the initial tax consequences of a properly declared and paid dividend. Corporate planners must be aware of the potential for IRS scrutiny of transactions that appear to manipulate distributions to avoid tax liabilities. Taxpayers reporting dividends are expected to report them as taxable income. This case is relevant in any instance of a corporate distribution, including stock redemptions and liquidations, and any cases where there is an argument concerning earnings and profits.

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