DeGroff v. Commissioner, 54 T. C. 59 (1970)

In a corporate reorganization, distributions to shareholders are taxable as dividends if they have the effect of a dividend and are supported by corporate earnings and profits.

Summary

In DeGroff v. Commissioner, the Tax Court ruled that an informal transfer of a corporation's business operations to another corporation controlled by the same shareholders constituted a reorganization under IRC §368(a)(1)(D). Mark and Loveta DeGroff owned three corporations involved in the production and sale of therapeutic devices. When they informally transferred the business of one selling corporation (Medco Electronics) to another (Medco Products), the court held that this was a reorganization, not a liquidation. As a result, distributions to the DeGroffs from Medco Electronics' earnings and profits were treated as dividends under IRC §356(a)(2), taxable as ordinary income rather than capital gains.

Facts

The DeGroffs owned three corporations: Medco Mfg. (manufacturing), Medco Products (selling), and Medco Electronics (selling a specific device called the Medco-sonlator). All were equally owned by the DeGroffs. In 1963, they informally transferred the business operations of Medco Electronics to Medco Products, which continued to sell the Medco-sonlator using the same personnel and facilities. At the time of the transfer, Medco Electronics had accumulated earnings and profits of $124,030, which were distributed to the DeGroffs. The DeGroffs reported this as capital gain from the liquidation of Medco Electronics, but the IRS treated it as a dividend.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the DeGroffs' 1964 income tax, treating the distributions as dividends rather than capital gains. The DeGroffs petitioned the Tax Court for a redetermination of the deficiency, arguing that the transaction was a liquidation under IRC §§331 and 346, not a reorganization.

Issue(s)

1. Whether the transfer of Medco Electronics' business to Medco Products constituted a reorganization under IRC §368(a)(1)(D)?
2. If so, whether the distributions to the DeGroffs were taxable as dividends under IRC §356(a)(2)?

Holding

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1. Yes, because the transfer met the requirements of IRC §368(a)(1)(D), including the transfer of substantially all of Medco Electronics' assets to Medco Products, which was controlled by the same shareholders.
2. Yes, because the distributions had the effect of a dividend and were supported by Medco Electronics' earnings and profits, they were taxable as dividends under IRC §356(a)(2).

Court's Reasoning

The court applied IRC §368(a)(1)(D), which defines a reorganization as a transfer of assets if the transferor or its shareholders control the transferee corporation. The key issue was whether "substantially all" of Medco Electronics' assets were transferred. The court found that despite the informal nature of the transfer, the business operations and intangible assets (like the sales network and goodwill) were effectively transferred to Medco Products. The court rejected the DeGroffs' argument that a valuable license agreement was not transferred, finding it was informally succeeded to by Medco Products. The court also noted that even if the transfer did not qualify under §368(a)(1)(D), it might have qualified as a reorganization under §368(a)(1)(F), which has no "substantially all" requirement.

Practical Implications

This decision underscores the importance of substance over form in corporate reorganizations. Even informal transfers can trigger reorganization treatment if they result in the continuation of business operations. Taxpayers should be cautious about treating distributions as liquidating dividends when the underlying business continues under a different corporate structure. The case also highlights the significance of intangible assets in determining whether "substantially all" of a corporation's assets have been transferred. Practitioners should consider the broader implications of informal business arrangements on tax treatment. Subsequent cases have cited DeGroff in analyzing similar reorganization scenarios, particularly in the context of family-owned businesses.

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