H. H. Robertson Co. v. Commissioner, 59 T. C. 53 (1972)

When a foreign subsidiary distributes appreciated property as a dividend, its earnings and profits are reduced only by the property's basis, not its fair market value, and the foreign tax credit cannot exceed the foreign taxes paid on the accumulated profits from which the dividend is paid.

Summary

H. H. Robertson Co. sought to liquidate its foreign subsidiary, Robertson Holdings, under Section 367, requiring it to include Robertson Holdings' earnings and profits as a dividend. The dispute centered on whether the 1964 distribution of appreciated stock reduced Robertson Holdings' earnings and profits by its fair market value or basis, and how to compute the 1965 foreign tax credit. The court held that earnings and profits were reduced by the basis of the stock under Section 312(a)(3), resulting in a higher dividend upon liquidation. Additionally, the foreign tax credit was limited to the foreign taxes paid on the accumulated profits from which dividends were distributed, not exceeding those profits.

Facts

H. H. Robertson Co. (petitioner) sought a ruling under Section 367 to liquidate its wholly owned foreign subsidiary, Robertson Holdings, without recognizing gain. In 1964, Robertson Holdings distributed 77,000 shares of its subsidiary's stock to petitioner as a dividend. These shares had a basis of $251,650 and a fair market value of $1,925,000. Petitioner argued that the earnings and profits of Robertson Holdings should be reduced by the fair market value of the distributed shares, while the Commissioner contended it should be reduced by the basis. In 1965, Robertson Holdings paid a cash dividend of $3,366,658 and was liquidated, distributing its remaining assets to petitioner.

Procedural History

Petitioner filed for a Section 367 ruling to liquidate Robertson Holdings without recognizing gain. After discussions with the IRS, petitioner withdrew its request for a ruling on the amount of earnings and profits to be included as a dividend. The IRS issued a ruling requiring petitioner to include Robertson Holdings' earnings and profits as a dividend upon liquidation. The Commissioner determined deficiencies in petitioner's 1964 and 1965 income taxes, leading to this case before the U. S. Tax Court.

Issue(s)

1. Whether the distribution of appreciated stock in 1964 reduced Robertson Holdings' earnings and profits by the fair market value of the stock or by its basis, as required by Section 312(a)(3)?
2. Whether the foreign tax credit for 1965 can exceed the foreign taxes paid on the

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accumulated profits from which the dividends were distributed, as computed under Section 902?

Holding

1. No, because Section 312(a)(3) explicitly requires that earnings and profits be reduced by the basis of the distributed property, not its fair market value.
2. No, because Section 902 limits the foreign tax credit to the proportion of foreign taxes paid on the accumulated profits from which dividends are paid, and cannot exceed those profits.

Court’s Reasoning

The court reasoned that Section 312(a)(3) clearly mandates that earnings and profits be reduced by the basis of distributed property, not its fair market value. This interpretation was supported by the legislative history, which contemplated that a distributee could be taxed on dividends exceeding the distributing corporation’s historical earnings and profits by the amount of the property’s appreciation. Regarding the foreign tax credit, the court found that Section 902 limits the credit to the foreign taxes paid on the accumulated profits from which dividends are distributed. The court rejected petitioner’s argument that the full amount of the dividend should be used in the numerator of the Section 902 fraction, as this would allow a credit for taxes never paid, contrary to the statute’s purpose of eliminating double taxation.

Practical Implications

This decision clarifies that when a foreign subsidiary distributes appreciated property, its earnings and profits are reduced only by the property’s basis, impacting how domestic parent companies calculate taxable dividends upon liquidation. It also limits the foreign tax credit to the foreign taxes paid on the accumulated profits from which dividends are distributed, preventing a credit for taxes never imposed. This ruling affects how similar cases involving foreign subsidiaries and appreciated property distributions should be analyzed and emphasizes the importance of understanding the annual nature of accumulated profits under Section 902. Future cases may need to consider this precedent when calculating earnings and profits and foreign tax credits, particularly in the context of liquidations and distributions of appreciated property.

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