Darrow v. Commissioner, 64 T. C. 217 (1975)

The personal holding company tax must be strictly applied without a reasonable cause defense for failing to pay dividends during the taxable year.

Summary

In Darrow v. Commissioner, the U. S. Tax Court upheld the imposition of a 70% personal holding company (PHC) tax on Rendar Enterprises, Ltd. , for its 1968 fiscal year. Rendar, which derived over 80% of its income from rents, paid a dividend after its fiscal year ended, relying on its accountants' advice that this would avoid PHC status. The court ruled that dividends must be paid within the fiscal year to be considered under Section 563(c), and no reasonable cause defense exists for failing to do so. This decision emphasizes the strict statutory interpretation of PHC provisions, reinforcing the automatic imposition of the tax when criteria are met.

Facts

Rendar Enterprises, Ltd. , had a fiscal year ending July 31, 1968. On March 27, 1968, Rendar's board declared a $2,000 dividend to be paid on September 30, 1968, following advice from its accountants that this would prevent PHC classification. Over 80% of Rendar's income was from rents. Rendar paid the dividend on September 27, 1968, after its fiscal year ended. No dividends were paid during the fiscal year. Rendar was dissolved in August 1969.

Procedural History

The Commissioner determined a deficiency in Rendar's 1968 fiscal year taxes, asserting Rendar was a PHC subject to the 70% tax under Section 541. Rendar's trustee, Kenneth Farmer Darrow, petitioned the U. S. Tax Court, arguing the dividend paid in September should be considered as paid within the fiscal year under Section 563(c). The Tax Court decided in favor of the Commissioner.

Issue(s)

1. Whether dividends paid after the close of Rendar's 1968 fiscal year can be deemed as having been paid on the last day of the fiscal year under Section 563(c).

2. Whether a reasonable cause defense applies to the imposition of the personal holding company tax under Section 541.

Holding

1. No, because Section 563(b) limits the amount considered paid on the last day of the fiscal year to dividends actually paid during the fiscal year, and Rendar paid no dividends during its 1968 fiscal year.

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2. No, because the PHC provisions do not include a reasonable cause defense for failing to pay dividends during the fiscal year, as intended by Congress.

Court’s Reasoning

The court applied a strict interpretation of the PHC provisions, emphasizing that Congress intended the tax to be automatically levied without proving intent to avoid surtaxes. The court noted that Section 563(c) allows dividends paid within 2 1/2 months after the fiscal year to be considered as paid on the last day of the fiscal year, but this is subject to the limitation in Section 563(b), which requires dividends to be paid during the fiscal year. The court rejected Rendar’s argument that the post-fiscal year dividend should be considered as paid within the fiscal year, as no dividends were paid during the fiscal year. Additionally, the court dismissed Rendar’s reasonable cause defense, stating that the PHC provisions contain no such standard and that courts have consistently applied the provisions strictly. The court cited legislative history and prior case law to support its decision, emphasizing the automatic nature of the PHC tax imposition.

Practical Implications

This decision reinforces the strict application of PHC tax provisions, requiring corporations to pay dividends within their fiscal year to avoid PHC classification. It highlights the need for corporations to carefully plan dividend payments to comply with the statute, as no reasonable cause defense exists for failing to do so. The ruling affects how corporations with significant income from passive sources, such as rents, manage their tax liabilities. It also underscores the importance of understanding and adhering to the specific timing requirements of the PHC provisions. Subsequent cases have continued to apply the strict interpretation established in Darrow, further solidifying its impact on tax planning for corporations.

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