Estate of Ward T. McWhorter, Deceased, Lynn Mabry and Clayton W. McWhorter, Co-Executors, et al. , v. Commissioner of Internal Revenue, 69 T. C. 650 (1978)

Distributions of promissory notes by a corporation to shareholders are considered dividends when issued, not when declared, and net operating losses cannot be carried over in a corporate merger lacking continuity of interest.

Summary

Ozark Supply Co. , an electing small business corporation, declared dividends to its shareholders on August 28, 1970, payable October 1, 1970, in the form of promissory notes. The court ruled that these distributions constituted dividends on the date of issuance, October 1, 1970, rather than when declared, thus impacting the shareholders' tax liabilities. Additionally, when Ozark later acquired and merged with Benton County Enterprises, Inc. , it was not allowed to deduct Benton's pre-merger net operating loss due to the absence of a qualifying reorganization or liquidation under the Internal Revenue Code.

Facts

Ozark Supply Co. was an electing small business corporation until its election was terminated on October 1, 1970. On August 28, 1970, Ozark's board declared dividends to its shareholders, payable on October 1, 1970, in the form of promissory notes equal to each shareholder's undistributed taxable income as of September 30, 1970. Ozark subsequently purchased all stock of Benton County Enterprises, Inc. on April 12, 1971, and merged Benton into Ozark on April 30, 1971. Benton had a net operating loss prior to the merger, which Ozark attempted to deduct on its tax returns for the years ending September 30, 1971, and September 30, 1972.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes, asserting that the promissory note distributions were taxable dividends and that Ozark could not deduct Benton's pre-merger net operating loss. The case was brought before the United States Tax Court, where it was consolidated with related cases involving Ozark and its shareholders.

Issue(s)

1. Whether the distributions of promissory notes by Ozark to its shareholders on October 1, 1970, constituted a return of capital or distributions of earnings and profits.
2. Whether the purchase of Benton's stock by Ozark followed by the merger of Benton into Ozark qualified as an F reorganization under the Internal Revenue Code, allowing Ozark to deduct Benton's pre-merger net operating loss.

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Holding

1. No, because the distributions occurred on October 1, 1970, when the promissory notes were issued, and were dividends to the extent of earnings and profits.
2. No, because the transaction did not qualify as an F reorganization or any other type of reorganization or liquidation that would allow for the carryover of Benton's net operating loss, due to the lack of continuity of interest.

Court's Reasoning

The court determined that the promissory notes distributed by Ozark on October 1, 1970, constituted dividends on that date, not when declared on August 28, 1970. The court rejected the petitioners' argument of constructive distribution, citing the absence of a debtor-creditor relationship on September 30, 1970, and the lack of evidence of such a relationship in Ozark's financial records. Regarding the merger with Benton, the court found that the transaction did not qualify as an F reorganization under Section 368(a)(1)(F) of the Internal Revenue Code, as there was no continuity of proprietary interest after Ozark purchased and then quickly liquidated Benton. The court emphasized that the transaction did not meet the requirements for a reorganization under any section of the Code and was subject to Section 334(b)(2), which precluded the carryover of Benton's net operating loss to Ozark.

Practical Implications

This decision clarifies that corporate distributions in the form of promissory notes are treated as dividends on the date they are issued, not when declared, affecting the timing of tax liabilities for shareholders. For corporate mergers, it underscores the necessity of continuity of interest for net operating loss carryovers, impacting how corporations structure acquisitions and mergers to achieve tax benefits. Businesses must carefully plan and document their transactions to ensure compliance with tax regulations regarding reorganizations and liquidations. Subsequent cases have cited McWhorter for its interpretation of constructive distributions and the requirements for reorganizations under the Internal Revenue Code.

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