Estate of Kirk v. Commissioner, 75 T. C. 779 (1980)

Distributions by a corporation after termination of its Subchapter S election are taxable as dividends if not made within the grace period.

Summary

In Estate of Kirk v. Commissioner, the Tax Court ruled that a distribution from Music City Songcrafters, Inc. to Eugene Kirk was taxable as a dividend because it occurred after the termination of the corporation's Subchapter S election. The termination was triggered when Kirk's wife, Mary, received shares without consenting to the election. The court upheld the validity of the regulation that distributions outside the 2. 5-month grace period following the taxable year's end are taxable, emphasizing that the regulation was consistent with the statutory framework of Subchapter S corporations.

Facts

Eugene Kirk received two distributions from Music City Songcrafters, Inc. in 1972: $5,000 on July 24 and $7,157. 03 on November 11. On November 14, Eugene gifted 5% of the corporation's stock to his wife, Mary, who did not consent to the corporation's Subchapter S election, automatically terminating the election as of July 1, 1972. The corporation had previously elected Subchapter S status starting July 1, 1970, and Eugene owned 100% of its stock until the gift to Mary.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Eugene and Mary Kirk's 1972 income tax, asserting the $7,157. 03 distribution was taxable. After Eugene's death, his estate was substituted as a party. The Tax Court addressed the sole issue of the taxability of the November distribution, ultimately deciding in favor of the Commissioner.

Issue(s)

1. Whether the distribution of $7,157. 03 by Music City Songcrafters, Inc. to Eugene Kirk on November 11, 1972, was taxable as a dividend after the termination of the corporation's Subchapter S election.

Holding

1. Yes, because the distribution occurred outside the 2. 5-month grace period provided by section 1375(f) and after the effective date of the termination of the Subchapter S election, making it taxable under sections 301 and 316 as a dividend from earnings and profits.

Court's Reasoning

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The court reasoned that the regulation (sec. 1. 1375-4(a), Income Tax Regs.) was valid and consistent with the statute. It emphasized that upon termination of a Subchapter S election, a corporation reverts to regular corporate status for the entire taxable year, subjecting distributions to the dividend rules of sections 301 and 316. The court rejected the petitioners' argument that the regulation was invalid because it conflicted with section 1375(d)(1), noting that the regulation followed the statutory framework by not allowing nondividend distributions of previously taxed income after the termination of the Subchapter S election, except within the grace period. The court cited Commissioner v. South Texas Lumber Co. and United States v. Correll to support its stance on the deference given to regulations that are reasonable and consistent with statutory mandates.

Practical Implications

This decision clarifies that distributions made after the termination of a Subchapter S election, but within the same taxable year, are taxable as dividends unless they fall within the grace period. Legal practitioners should advise clients to ensure all shareholders consent to the Subchapter S election to avoid unintentional termination. Businesses must be aware of the timing of distributions relative to changes in ownership and the termination of their Subchapter S status. This ruling has been cited in subsequent cases dealing with the tax treatment of distributions following the termination of a Subchapter S election, reinforcing its impact on corporate tax planning and compliance.

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