Johnson v. Commissioner, 77 T. C. 837 (1981)

Only the IRS, not taxpayers, may reallocate dividends from a subchapter S corporation among family member shareholders.

Summary

Richard and Ruth Johnson, who controlled a subchapter S corporation with their children, attempted to reallocate dividends they received to their children on their tax returns, arguing that the actual disproportionate distribution was a waiver of dividends by their children. The IRS challenged this, asserting that only they could reallocate dividends under section 1375(c) and related regulations. The Tax Court agreed with the IRS, holding that taxpayers cannot unilaterally reallocate dividends. This ruling clarifies that the power to adjust dividend allocations among family shareholders in subchapter S corporations lies solely with the IRS, impacting how such distributions are reported for tax purposes.

Facts

Richard and Ruth Johnson owned 75% of Johnson Oil Co. , Inc. , an Indiana corporation that elected to be treated as a subchapter S corporation. Their children, Richard Jr. and Jennifer, owned the remaining 25%. From 1975 to 1977, Johnson Oil distributed cash dividends disproportionately among its shareholders. The Johnsons reported these distributions on their tax returns, reallocating some of their dividends to their children, citing section 1. 1375-3(d) of the Income Tax Regulations, which they interpreted as allowing them to treat the disproportionate distribution as a waiver of dividends by their children.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency for the tax years 1975-1977, rejecting the Johnsons' reallocation and asserting they should report the full amount of dividends they received. The Johnsons petitioned the Tax Court, which heard the case and issued its decision in 1981.

Issue(s)

1. Whether taxpayers can reallocate dividends received from a subchapter S corporation among family member shareholders under section 1375(c) and section 1. 1375-3(d) of the Income Tax Regulations.

Holding

1. No, because only the IRS has the authority to reallocate dividends under section 1375(c) and the related regulations; taxpayers cannot unilaterally reallocate dividends.

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Court’s Reasoning

The court focused on the language of section 1375(c) and section 1. 1375-3 of the regulations, which clearly state that the IRS, not taxpayers, may apportion or allocate dividends among family shareholders. The court noted that section 1. 1375-3(d) must be read in context with the entire regulation, which does not grant shareholders the right to reallocate distributions differently from how they were actually distributed. The court compared this to section 482, where it is also established that only the IRS can make allocations. The court rejected the Johnsons’ argument that the disproportionate distributions constituted a waiver of dividends by their children, as the regulations do not provide for such taxpayer-initiated reallocations. The court concluded that without an IRS-initiated reallocation, the Johnsons had to report the dividends as actually received.

Practical Implications

This decision underscores that shareholders of subchapter S corporations cannot unilaterally adjust the tax treatment of dividends received, even among family members. It reinforces the IRS’s exclusive authority to reallocate income under section 1375(c), impacting how tax professionals advise clients on reporting subchapter S distributions. Practitioners must ensure that clients report dividends as received unless the IRS makes an allocation. This ruling may influence family-owned businesses to structure their dividend distributions carefully, as they cannot rely on post-distribution adjustments for tax purposes. Subsequent cases, such as *Interstate Fire Insurance Co. v. United States* and *Morton-Norwich Products, Inc. v. United States*, have similarly upheld the principle that only the IRS can invoke section 482 and related provisions for income reallocation.

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