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Income Tax: Distribution of Appreciated Property as Dividend by Corporation with Impaired Capital and Operating Loss

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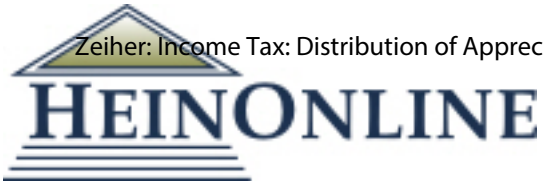

The Florida view that a legal presumption vanishes upon the presentation of competent countervailing evidence is in line with the prevailing view in American jurisdictions.[12] The Florida Court has not yet decided how much evidence is required to overcome the presumption of consent in connection with the negligent operation of a vehicle by one other than the owner. When the bond between that which is presumed and that which is known is strong, the court should require more countervailing evidence before disposing of the presumption.

Perhaps the Court's extreme position in the railroad cases is justified. The probability of the railroad's being the negligent party in an accident is not nearly so strong as the probability that a person who is driving another's car is doing so with the owner's express or implied consent. Consequently the presumption in the automobile statute should not be as easily dispelled as the presumption created by the railroad statute.

JOE S. EVERETT

INCOME TAX: DISTRIBUTION OF APPRECIATED PROPERTY AS DIVIDEND BY CORPORATION WITH IMPAIRED CAPITAL AND OPERATING LOSS

Michael P. Erburu, P-H 1955 T.C. Rep. Dec. ¶23,104

Petitioner, a shareholder in the Transamerica Corporation, received in 1951 a dividend in kind[1] consisting of stock in another corporation. The fair market value of the stock had appreciated over its cost to the Transamerica Corporation. On the date of distribution Transamerica had a capital deficit and had suffered an operating loss for the year. The value of the distribution received by petitioner in 1951 exceeded the cost of his stock in the Transamerica Corporation. The Commissioner of Internal Revenue determined a deficiency in

[12] *E.g.*, New York Life Ins. Co. v. Gamer, 303 U.S. 161 (1938); Louisville & N. R.R. v. Marbury Lumber Co., 125 Ala. 237, 28 So. 438 (1900); Watkins v. Prudential Ins. Co., 315 Pa. 497, 173 Atl. 644 (1934).

[1] For a discussion of this type of dividend see Mintz and Plumb, *Dividends in Kind — The Thunderbolts and the New Look*, 10 TAX L. REV. 41 (1954) and postscript, 405 (1955).

petitioner's 1951 tax return, contending that petitioner had received dividend income to the extent that the fair market value of the dividend in kind at the date of distribution exceeded the cost to the corporation. Upon petition to the Tax Court for redetermination of the deficiency, HELD, the fair market value of the distributed property should be applied in reduction of the basis of petitioner's stock in the Transamerica Corporation and any excess taxed as a gain on the sale or exchange of property, pursuant to section 115 (d) of the Internal Revenue Code of 1939.[2]

The problem presented is whether any or all of the corporate distribution is a dividend for tax purposes. In construing sections 115 (a), (b)[3] and 115 (j)[4] of the 1939 Internal Revenue Code, the Tax Court has consistently held that the fair market value of property distributed is taxable to the shareholder as a dividend only to the extent of available earnings and profits on the date of distribution and that the excess is not a dividend but a return of capital within the meaning of section 115 (d).[5]

The Tax Court's theory was rejected by the Second and Third

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[2]"If any distribution made by a corporation to its shareholders . . . is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property . . ." (with certain exceptions not material here).

[3]Sec. 115 (a) defined a dividend as any distribution made by a corporation to its shareholders, whether in money or property, out of either the corporation's earnings accumulated after Feb. 21, 1933, or earnings and profits of the taxable year. Sec. 115 (b) stated that every distribution was conclusively presumed to be made from earnings and profits and from those most recently accumulated.

[4]"If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder."

[5]Timken v. Commissioner, 47 B.T.A. 494 (1942), *aff'd,* 141 F.2d 625 (6th Cir. 1944); Paulina DuPont Dean, 9 T.C. 256 (1947); Jane Easton Bradley, 9 T.C. 115 (1947); Vivien Dulany Murphy, P-H 1946 T.C. Mem. Dec. ¶46,006; G. W. Grandin, P-H 1945 T.C. Mem. Dec. ¶45,353; Estate of John H. Acheson, P-H 1944 T.C. Mem. Dec. ¶44,392; Elizabeth N. Sager, P-H 1944 T.C. Mem. Dec. ¶44,359; Charles Russell McLean, P-H 1944 T.C. Mem. Dec. ¶44,357; Henry S. McKee, P-H 1944 T.C. Mem. Dec. ¶44,228; Carl A. Fisher, P-H 1944 T.C. Mem. Dec. ¶44,132; Corinne S. Koshland, P-H 1943 T.C. Mem. Dec. ¶43,472; Avalon Inv. Corp., P-H 1942 B.T.A. Mem. Dec. ¶42,496. *Contra,* Commissioner v. Wakefield, 139 F.2d 280 (6th Cir. 1943), based upon the dubious proposition that property purchased out of earnings and profits and subsequently distributed represents earnings and profits and therefore was a dividend under §115 (a).

Circuits in *Commissioner v. Hirshon Trust*[6] and *Commissioner v. Godley's Estate*[7] respectively. In each of these cases the corporation's earnings and profits available for distribution covered the adjusted basis of the property distributed but did not cover the fair market value at the date of distribution. Both courts held that the full fair market value of the property at the time of distribution was taxable to the stockholders of the distributing corporation. These decisions were based upon the proposition that corporate assets should be carried at historical cost and that earnings and profits should be charged with the cost of the property distributed. Therefore, if the earnings and profits covered the adjusted basis of the property distributed, it was a dividend within the definition of section 115 (a) and the full market value of the property distributed would be taxable to the shareholder under section 115 (j).

The court in the *Hirshon* case rejected the argument that the excess of the market value of the property distributed over the earnings and profits at the date of distribution was not a dividend within the meaning of section 115 (d). The court stated that the caption of section 115 (d), "OTHER DISTRIBUTIONS FROM CAPITAL," indicates that it was "designed to subject to capital gains taxation those distributions which left the capital of the corporation impaired."[8] The opinion implied that under the facts of the case section 115 (d) did not apply because the adjusted basis of the property distributed was covered by the earnings and profits, thereby precluding the impairment of the distributing corporation's capital earnings.

The *Hirshon* and *Godley* theory does not supply a direct answer to the problem that arises when the distributing corporation has a deficit and no current earnings or profits. The Commissioner, however, interpreted the language of the *Hirshon* case to support the argument that, whether a corporation has earnings and profits or a deficit, the test for determining the amount of the distribution taxable as a dividend is whether the distribution impairs capital of the distributing corporation. He therefore concluded that, since the appreciated value of the property distributed did not impair the corporation's capital, it was taxable as a dividend to the shareholder. In rejecting this argument the Tax Court properly pointed out that in order for the *Hirshon* and *Godley* theory to apply the distribution had to be

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[6]213 F.2d 523 (2d Cir.), *cert. denied*, 75 Sup. Ct. 85 (1954).
[7]213 F.2d 529 (3d Cir.), *cert. denied*, 75 Sup. Ct. 86 (1954).
[8]213 F.2d 523, 528 (3d Cir. 1954).

characterized as being out of earnings and profits and that, since there were no earnings and profits, such a characterization was impossible.

The Commissioner's "impairment-of-capital" test faces the same problems under the 1954 Code as under the 1939 Code. Section 301 (c) provides that the portion of the distribution that is a dividend shall be included in the shareholder's gross income and that the portion of the distribution that is not dividend shall be applied against and reduce the basis of the shareholder's stock in the distributing corporation. Section 316 defines *dividend* in the same manner as section 115 (a), (b) of the 1939 Code,[9] thereby requiring dividends to be out of earnings and profits. Under the 1939 Code *General Utilities and Operating Co. v. Helvering*[10] was generally accepted as holding that a corporation realized no taxable gain upon the distribution of appreciated property, thus precluding any increase in earnings and profits upon such distribution.[11] Section 311 has adopted the general rule of the *General Utilities* decision.[12] The Commissioner, in supporting the impairment-of-capital test, may take the position that unrealized income may increase earnings and profits, since the earnings and profits concept is not closely related to that of taxable income. While it is true that there is a distinction between these two concepts. the decisions indicate that the concept of realization of gain is as much a part of the determination of earnings and profits as of taxable income.[13] Therefore the holding in the instant case seems to be as correct under the 1954 Code as it was under the 1939 Code.

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[9]See note 3 *supra.*

[10]296 U.S. 200 (1935).

[11]Commissioner v. Timken, 141 F.2d 625 (6th Cir. 1944), *affirming* 47 B.T.A. 494 (1942); Paulina DuPont Dean, 9 T.C. 256 (1947); Jane Easton Bradley, 9 T.C. 115 (1947).

[12]S. REP. No. 1622, 83d Cong., 2d Sess. 247 (1954).

[13]See note 11 *supra.*