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The Income Taxation of Corporate Distributions under the Internal Revenue Code of 1954: An Addendum

Harold G. Wren*

In his article on corporate distributions in an earlier issue of the *California Law Review*,¹ the writer noted that the Commissioner had taken the position in his proposed regulations under subchapter C² that the 1954 Code did not change the law with regard to the income taxation of property dividends to the individual shareholder. Both the Second and Third Circuits had held that, under the Internal Revenue Code of 1939, where the declaring corporation had sufficient earnings and profits to cover the adjusted basis of the property distributed, the entire fair market value of the property would be taxable as a dividend to the recipient shareholder.³

The writer has found nothing in the plain meaning of the statute that warrants the conclusion that this doctrine is different under the new Code.⁴ Even those who claim that the Code changed the law concede that it is difficult to "find the change on the face of the statute, except by some close semantic reasoning."⁵ As for the legislative history, the only reference to the problem is a statement in the report of the Senate Finance Committee with respect to the effect of a distribution of appreciated property on earn-

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¹ Wren, *The Income Taxation of Corporate Distributions under the Internal Revenue Code of 1954*, 43 CALIF. L. REV. 268 (1955).

² Proposed Reg. § 1.316-1(a) (2), (3), 19 FED. REG. 8253 (1954), quoted in Wren, *supra*, note 1, at 274 n.51.

³ Commissioner of Internal Rev. v. *Hirshon Trust*, 213 F.2d 523 (2d Cir. 1954), *cert. denied*, 348 U.S. 861; Commissioner of Internal Rev. v. *Godley's Estate*, 213 F.2d 529 (3rd Cir. 1954), *cert. denied*, 348 U.S. 862.

⁴ Except for the cryptic remark that a "distribution of property" [the term "property" is defined to mean money or other property except stock dividends or stock rights, INT. REV. CODE OF 1954, § 317(a)] under § 301 shall also be treated as a distribution of property under § 316(a), the definition of a dividend in the old Code is identical with that of the new Code. INT. REV. CODE OF 1939, § 115(a), 53 STAT. 46; INT. REV. CODE OF 1954, § 316(a).

⁵ Mintz and Plumb, *Dividends in Kind—The Thunderbolts and the New Look*, 10 TAX L. REV. 41, 72 n.154 (1954). Messrs. Mintz' and Plumb's explanation of the statutory language is as follows: "The *Godley* and *Hirshon* theory was that old section 115(a) defined a dividend as any distribution out of earnings and profits, and that cost determined what was 'out of earnings. Then, if it was a dividend, section 115(j) made its fair market value taxable, regardless of the relation of value to earnings. The same ingredients are still in the law, but they have been rearranged. A dividend is still any distribution out of earnings and profits (I. R. C. § 316(a)), but "distribution" is now a defined term, and the old value test of former section 115(j) has been incorporated in the definition. *The amount of the distribution* in the case of non-corporate distributees is the value of the property received, and that portion of *the distribution, i.e., of the value, which is a dividend, i.e., out of earnings, is taxed.*" *Ibid.* (Emphasis is Messrs. Mintz' and Plumb's.)

ings and profits under section 312 of the new Code. The Committee said:⁶

If the distribution is in property the amount of the decrease [to earnings and profits] is by the adjusted basis of such property. This rule is applicable whether the property has appreciated or depreciated in value. Thus, if property with a value of \$100 is distributed but if there are only \$75 of earnings and profits from which the distribution can be made, *the taxable amount will be only \$75*. If the property cost the corporation only \$50, however, its earnings and profits will be reduced only by \$50, and \$25 will remain in its earnings and profits account.

While the discussion of the Committee at this point was limited to the effect on earnings and profits, the phrase italicized above became the basis for a much more explicit statement with reference to the effect of such a distribution on the recipient stockholder. In discussing section 312 in its summary of the new provisions of the Code, the staff of the Joint Congressional Committee on Taxation said:⁷

On a distribution by a corporation with respect to its stock, the general rule is that corporate earnings and profits (to the extent thereof) are decreased by the total of . . . the adjusted basis of any . . . property [other than money or obligations of the declaring corporation] which is distributed.

The application of this general rule in conjunction with the other provisions of part I determining when a distribution has dividend consequences is contrary to two recent court decisions. [Citing *Hirshon Trust and Godley*]. For example, under the general rule, if a corporation has earnings and profits of \$75 and property with a fair market value of \$100 but an adjusted basis in the hands of the corporation of only \$50 is distributed as a dividend, the corporate earnings and profits are reduced by \$50 and *the recipient stockholder is treated as having received a dividend only to the extent of the corporate earnings and profits at the time of distribution*, in this case \$75.

In his final regulations under subchapter C, the Commissioner has taken the position that as to property dividends on or after June 22, 1954, "the amount of the distribution which is a dividend to [the stockholders] may not exceed the earnings and profits of the distributing corporation."⁸ He illustrates the rule with the following example:⁹

X and Y, individuals, each own one-half of the stock of Corporation A which has earnings and profits of \$10,000. Corporation A distributes property having a basis of \$6,000 and a fair market value of \$16,000 to its shareholders, each shareholder receiving property with a basis of \$3,000 and with a fair market value of \$8,000 in a distribution to which section 301 applies. The amount taxable to each shareholder as a dividend under section 301(c) is \$5,000.

⁶ S. REP. NO. 1622, 83d Cong., 2d Sess. 248 (1954). (Emphasis added.)

⁷ STAFF, JOINT CONGRESSIONAL COMMITTEE ON TAXATION, SUMMARY OF THE NEW PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954 36 (1955). (Emphasis added.)

⁸ T. D. 6152, 1955 INT. REV. BULL. NO. 50 at § 1.316-1(a)(2).

⁹ *Id.* § 1.316-1(a)(3).

Treasury Decision 6152 goes further than the Staff summary (which in turn went further than the Finance Committee), since it purports to be an interpretation of section 316, which defines a dividend, and not simply a discussion of the effect of a property dividend on earnings and profits.

It seems probable that the Commissioner reversed himself because of the Staff summary, which appeared long after the enactment of the Code, and some months after the Commissioner's proposed regulations. It is to be hoped that the use of such sources¹⁰ to find "Congressional intent" will be confined to situations where, as here, the taxpayer stands to benefit.

¹⁰ For cases where no less curious sources were used, see *e.g.*, *United States v. Public Utilities Commission of California*, 345 U.S. 295, 319 (1953) (Jackson, J., concurring); *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384, 395 (1951) (Jackson, J., concurring).