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## Taxation - Federal Income Tax - Extent to Which A Dividend in Kind is Ordinary Income Under the Internal Revenue Code

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TAXATION—FEDERAL INCOME TAX—EXTENT TO WHICH A DIVIDEND IN KIND IS ORDINARY INCOME UNDER THE INTERNAL REVENUE CODE<sup>1</sup>—Taxpayer, a corporate shareholder, received from the corporation a distribution of property which had appreciated in value over its adjusted cost. The earnings and profits of the corporation were sufficient to cover the adjusted cost of the property distributed, but were not sufficient to cover its full fair market value at the time of distribution. The Tax Court held that the fair market value of the distribution was taxable as a dividend only to the extent of the corporation's earnings and profits. On appeal, *held*, reversed. In determining whether a distribution in kind is a dividend under section 115(a), the earnings and profits of the corporation are to be charged with the adjusted basis of the property distributed, without regard to any unrealized appreciation in its value. Since the corporation's earnings and profits were sufficient to cover the adjusted cost of the property herein distributed, the entire distribution is a dividend, and is taxable, under section 115(j), to the full extent of its fair market value at the time of distribution. *Commissioner v. Hirshon Trust*, (2d Cir. 1954) 213 F. (2d) 523; *Commissioner v. Godley's Estate*, (3d Cir. 1954) 213 F. (2d) 529.

Under the Internal Revenue Code of 1954, as under the 1939 code, distributions of property by a corporation to its shareholders constitute dividends, taxable to the latter as ordinary income, provided that the corporation has earnings and profits sufficient to cover the distribution at the close of the taxable year in

<sup>1</sup> Unless otherwise indicated, all references to code provisions in the text are references to the 1939 code.

which it is made.<sup>2</sup> If a given distribution is a dividend in kind, it is gross income to the shareholder in an amount equal to its fair market value.<sup>3</sup> The problem presented by the principal case, however, has been the subject of disagreement among the courts. Its solution turns upon whether sections 115(a) and (b), which determine the character of a distribution, also determine the extent to which a dividend in kind is subject to dividend taxation. Until quite recently, the courts generally have held that that portion of the fair market value of the property distributed which is in excess of the corporation's earnings and profits should first be applied to reduce the basis of the distributee's stock, any balance being taxable as a capital gain.<sup>4</sup> These cases rest upon the theory that sections 115(a) and (b) not only determine the character of the distribution, but also measure the extent to which a dividend in kind is ordinary income. This analysis proceeds as follows: (1) there can be a taxable dividend only to the extent that earnings and profits are available for distribution in the taxable year;<sup>5</sup> (2) unrealized appreciation over cost of the distributed property does not constitute earnings and profits to the distributing corporation;<sup>6</sup> (3) since unrealized appreciation in the value of the property distributed is excluded in measuring the corporation's earnings and profits for the purpose of determining the extent to which the distribution is a dividend, it likewise should be excluded in determining how much of the distribution is subject to dividend taxation.<sup>7</sup> The better view, however, would appear to be that propounded in the principal cases. Where the earnings and profits of the distributing corporation are sufficient to cover the adjusted cost of the property distributed, the distributee is taxable under section 115(j) upon the full fair market value of the property distributed, notwithstanding the earnings and profits of the distributing corporation are insufficient to cover its appreciation in value over cost.<sup>8</sup> These cases rest upon the theory that for purposes of characterizing a distribution as a dividend, the sole relevant test is from the standpoint of the distributing corporation, and from that standpoint the fair market value of the property distributed

<sup>2</sup> I.R.C. (1939), §§22(a), 115(a) and (b); I.R.C. (1954), §§301, 316(a).

<sup>3</sup> I.R.C. (1939), §115(j); I.R.C. (1954), §301(b).

<sup>4</sup> I.R.C. (1939), §115(d); *R. D. Merrill Co.*, 4 T.C. 955 (1945); *Jane Easton Bradley*, 9 T.C. 115 (1947); *Paulina du Pont Dean*, 9 T.C. 256 (1947). *National Carbon Co.*, 2 T.C. 57 (1943), by implication upholds this view. *Commissioner v. Timken*, (6th Cir. 1944) 141 F. (2d) 625, is also cited for this proposition, although it does not actually so hold. Cf. *Raum*, "Dividends in Kind: Their Tax Aspects," 63 HARV. L. REV. 593 at 608 (1950).

<sup>5</sup> I.R.C. (1939), §§115(a) and (b); *R. D. Merrill Co.*, note 4 supra; *Jane Easton Bradley*, note 4 supra; *Paulina du Pont Dean*, note 4 supra.

<sup>6</sup> *General Utilities and Operating Co. v. Helvering*, 296 U.S. 200, 56 S.Ct. 185 (1935); *Jane Easton Bradley*, note 4 supra; *Paulina du Pont Dean*, note 4 supra.

<sup>7</sup> *Jane Easton Bradley*, note 4 supra; *Paulina du Pont Dean*, note 4 supra.

<sup>8</sup> See *Binzel v. Commissioner*, (2d Cir. 1935) 75 F. (2d) 989, cert. den. 296 U.S. 579, 56 S.Ct. 90 (1935); *Commissioner v. Wakefield*, (6th Cir. 1943) 139 F. (2d) 280; *Equitable Securities Corp. v. United States*, (D.C. Tenn. 1954) 122 F. Supp. 722.

is immaterial.<sup>9</sup> Therefore, if earnings and profits of the distributing corporation are sufficient to cover the adjusted cost of the property distributed, the entire distribution is a dividend. Once it is determined, however, that the distribution is a dividend, its amount is governed solely by section 115(j), and for that purpose the earnings and profits of the corporation are immaterial.<sup>10</sup> Since section 115(j) is simply a valuation provision which is applicable only after it is determined that a given distribution is a dividend, it would appear that sections 115(a) and (b) do not determine the extent to which a dividend in kind is ordinary income. If such were the case, section 115(j) would be superfluous.

Under the 1954 code, however, the provision defining a dividend in kind<sup>11</sup> may be interpreted to determine the extent to which a dividend in kind is ordinary income. Whereas the 1939 code first defines a dividend in kind<sup>12</sup> and then provides for its valuation,<sup>13</sup> the 1954 code first provides for a determination of the amount for the distribution<sup>14</sup> and then provided that that portion of the distribution which is a dividend shall be included in gross income.<sup>15</sup> Under the new code, therefore, it could be said that only that portion of the distribution which may be charged against the corporation's earnings and profits is taxable as a dividend.<sup>16</sup> Since under the new code only the adjusted basis of the property distributed may be charged against the earnings and profits of the corporation,<sup>17</sup> unrealized appreciation in the value of such property may be said to be taxable as a dividend only to the extent that there are earnings or profits from other sources sufficient to cover it.<sup>18</sup> It must be noted, however, that the language of section 301(c)(1), I.R.C. (1954), does not preclude the courts from applying the theory applied in the principal cases if they so desire.

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<sup>9</sup> Since unrealized appreciation in value of corporate assets may not be added to earnings and profits (*General Utilities and Operating Co. v. Helvering*, note 6 *supra*) in determining whether a distribution in kind is a dividend under §115(a), I.R.C. (1939), it may not be subtracted therefrom. Cf. Raum, "Dividends in Kind: Their Tax Aspects," 63 *HARV. L. REV.* 593 at 609 (1950).

<sup>10</sup> *Ibid.*

<sup>11</sup> I.R.C. (1954), §316(a).

<sup>12</sup> I.R.C. (1939), §§115(a) and (b).

<sup>13</sup> I.R.C. (1939), §115(j).

<sup>14</sup> I.R.C. (1954), §301(b)(1).

<sup>15</sup> I.R.C. (1954), §301(c)(1).

<sup>16</sup> In this connection, see proposed *Treas. Reg.* §1.301-1(a), 19 *FED. REG.* 8237 (Dec. 11, 1954).

<sup>17</sup> I.R.C. (1954), §312(a)(3).

<sup>18</sup> I.R.C. (1954), §316(a); *National Carbon Co.*, note 4 *supra*.