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Unrealized Appreciation: Worthless Notes Distributed as Dividend - Recoveries Taxable to the Corporation-Distributor

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make his levy upon property of the judgment debtor as soon as possible after obtaining judgment. *E. W. Parkhill.*

UNREALIZED APPRECIATION: WORTHLESS NOTES DISTRIBUTED AS DIVIDEND—RECOVERIES TAXABLE TO THE CORPORATION-DISTRIBUTOR

"THE Treasury continues to parade through the Tax Court a series of cases attempting to tax unrealized appreciation of assets distributed as dividends in kind. In each case it attempts to distinguish the *General Utilities and Operating Co.* [*v. Helvering*][1] case and in each case the Tax Court applies the rule of that case,"[2] that is, that the corporation-distributor is not taxable on the appreciation.

In *Commissioner of Internal Revenue v. First State Bank of Stratford*[3] it would appear on first reading that the Treasury was successful in its attempt to tax the corporation on the appreciation of assets. Here the bank chose to distribute as dividends in kind charged off and worthless notes on which deductions had previously been taken and allowed. Upon substantial recoveries on the notes later in the taxable year, the Commissioner chose to determine income, taxable to the bank. Unsuccessful in the Tax Court, the Commissioner was sustained in his determination upon appeal, the Fifth Circuit Court of Appeals reversing, two judges dissenting.

Aside from the efforts of the Commissioner to assess unrealized appreciation to the distributor, the case for the Stratford Bank

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[10] Donald v. Davis, 208 S. W. (2d) 571 (Tex. Civ. App. 1948) *writ of error refused.*

[1] General Utilities and Operating Co. v. Helvering, 296 U. S. 200 (1935).

[2] 1 MONTGOMERY'S FEDERAL TAXES—CORPORATIONS AND PARTNERSHIPS, GROSS INCOME AND DEDUCTIONS, 158 (1946-47).

[3] Commissioner of Internal Revenue v. First State Bank of Stratford, 168 F. (2d) 1004 (C. C. A. 5th 1948), *Certiorari Denied,* 69 S. Ct. Memo Decis., Nov. 15, 1948.

was none too strong on its facts. Directors of the bank discussed payment of dividend and chose to distribute such dividend in kind, picking out only debts likely to yield collections, keeping those that were wholly bad. Evidence of recognition by the directors that the evidences of indebtedness had some value is contained in their resolution: "Whereas, this bank is the owner of . . . charged off notes, some of which may be collected . . . and the balance of . . . doubtful value."[4] The choice of payment of a dividend in kind was, according to the Fifth Circuit Court, an assignment made for tax purposes. The directors did not apportion the dividends to the stockholders, nor did they make any *pro rata* distribution. As to the notes, present collections were being made, and future collections were anticipated. These collections were made by an officer of the bank and though deposited in a special account, the debtors were not notified as to the change in ownership and payments as made were receipted in the name of the bank. The fact situation was then much as if the bank had declared a cash dividend to be paid when and as collected.[5] But the holding is much stronger and broader than a mere decision upon the facts.

Before entering into an analysis of the judicial opinions it would be well to restate briefly the holding of the *General Utilities Co.* case.[6] It was there held that the declaring corporation is not subject to tax upon the appreciation in value of a distribution in kind of stock of another corporation. This holding apparently lines up with the rule as promulgated by the Treasury:

> "No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition."[7]

In spite of the fact of this apparent line-up of decision and regu-

[4] First State Bank of Stratford, Petitioner, v. Commissioner of Internal Revenue, Respondent, 8 T. C. 831, 832 (1947).

[5] *Supra*, Note 3 at 1005.

[6] *Supra*, Note 1.

[7] Regulations III, Income Tax, § 29.22 (a)-20.

lation the *General Utilities Co.* case[8] was not necessarily within the spirit of the rule. The corporation was contemplating sale of stock it had purchased for two thousand dollars at a price over one million dollars, but before taking any action it made a distribution in kind and escaped a taxable gain. The case did not go without criticism by competent authority.[9]

However, the Tax Court[10] in the *Stratford Bank* case chose to rely on the *General Utilities Co.* case and held that the previous charge off and deductions as bad debts did not serve to distinguish, pointing to *National Bank of Commerce of Seattle,*[11] where six banks as part of a reorganization conveyed to taxpayer all their assets, including debts charged off earlier in the year. That case held recoveries in the following year on the charged off debts to be income to the taxpayer-transferee on a zero basis, and not income to the transferor banks.

The Tax Court also held the doctrine of anticipatory assignment as developed by the *Horst*[12] and *Eubank*[13] cases did not apply for the reason that in those cases there was no consideration for the transfer, and further held the doctrine of determination of income by retention of control as enunciated by *Helvering v. Clifford*[14] inapplicable in that here the stockholders could have enforced the dividend against the bank.

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[8] *Supra*, Note 1.

[9] Magill commented: "The corporation was held to realize no income, for it had not converted.... It is apparent that the increase in wealth of the distributing company, prior to the declaration of the dividend, was precisely the same in the two situations [sale by the corporation with distribution of proceeds and distribution of stock with sale by recipients]; and an economist might well contend that in both cases there was income capable of taxation." MAGILL, TAXABLE INCOME, 64 (Rev. ed. 1945).

Paul pointed out that the General Utilities Co. case was open to criticism in view of Kirby Lumber Co. v. U. S., 284 U. S. 1, "... Because of the rule that satisfaction of an obligation for a cash sum less than the fair amount of the obligation creates income to the extent of the difference to the debtor." PAUL, SELECTED STUDIES IN FEDERAL TAXATION, 171, (2nd Series, 1938). Paul had reference to the fact that the declaration of dividend though in kind was valued in dollars and payable in stock. In addition, Paul says that, "... The decision turned mainly on procedural points...." *Ibid*, 173.

[10] *Supra*, Note 4.

[11] 40 B. T. A. 72; *Affd.*, 115 F. (2d) 875 (C. C. A. 9th, 1940).

[12] Helvering v. Horst, 311 U. S. 112 (1940).

[13] Helvering v. Eubank, 311 U. S. 122 (1940).

[14] 309 U. S. 331 (1939).

The dissent in the Tax Court stated the broad principle that an assignment of anticipated future income will not relieve the assignor of the tax, and commented in a footnote,

> "If it be suggested that the present petitioner is on the accrual basis, the case against it becomes even stronger.... When the notes reached the point of being apparently collectible, as they clearly did in the present tax year, they were thereupon automatically accruable to petitioner as income."[15]

The Fifth Circuit Court of Appeals in its opinion very strongly reversed and held the bank taxable. The court, though declaring itself bound by the Tax Court's findings of good faith declaration of the dividend, and that the stockholders were owners, stated the law to be that subsequent recoveries of bad debts constitute taxable income to the extent that such were a tax benefit in the prior year. At about this point, Judge Sibley, in a concurring opinion, commented that, "In taking the deductions with tax benefits, the bank assumed an obligation." Having established the nature of any recovery on the notes as income it followed that the transaction was then an anticipatory assignment of income taxable to the assignor within the rule of the *Horst*[16] and *Eubank*[17] cases, the circuit court taking the position directly *contra* to the Tax Court that these cases could not be distinguished by their lack of a consideration.

Step three, to distinguish the *General Utilities Co.* case fell in place easily enough in that there the dividend was a distribution of a capital asset while here the distribution was of income by way of an anticipatory assignment thereof.

The measure of liability for tax is the amount of collections less recoveries for which no tax benefit has been received, and not fair market value as is provided by the code for measurement of a dis-

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[15] 8 T. C. 831, Footnote 2, 837 (1947).

[16] *Supra*, Note 12.

[17] *Supra*, Note 13.

tribution in kind,[18] as that provision relates to tax liability in the hands of the stockholder.

The time of realization under the anticipatory assignment doctrine occurs when the debt is paid to the assignee. "After assignment and prior to payment the tax liability is incomplete."[19]

SUMMARY

It is believed that the decision against the Stratford Bank has not obliterated the rule of the *General Utilities Co.* case nor made any particular inroad upon a *prima facie* interpretation of the provision promulgated in Section 29.22(a)-20;[20] both the rule and the provision being in accord that a partial distribution of assets will not impose upon the transferor tax liability for unrealized appreciation.

In other words, if the Stratford Bank had chosen to declare these notes as dividends prior to claiming a deduction and reducing the basis to zero, the transaction would have been a distribution in kind of capital assets.

However, the rule and provision is more limited than a quick reading would imply. A lineup of the cases in one, two, three order will best illustrate present doctrine.

1. "When a corporation declares a dividend of a specified amount and pays the dividend in property at its market value, gain or loss is realized,"[21] to the corporation.

There is a distinction between the *General Utilities* case and this rule in that here property at its market value was given to pay an acknowledged debt.

2. "If the dividend is declared and paid in property at cost to the corporation, no gain or loss is recognized."[22]

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[18] Regulations III, Income Tax, Sec. 115 (j).

[19] *Supra*, Note 3, at 1010.

[20] Regulations III, Income Tax.

[21] *Supra*, Note 2, 632, citing Callanan Road Improvement Co., 12 B. T. A. 1109 (A) (1928).

[22] *Supra*, Note 2, 632, citing Parkersburg Iron and Steel Co., 17 B. T. A. 74; *Affd.*, 48 F. (2d) 163 (C. C. A. 4th, 1931).

3. "Where a corporation itself contracts or negotiates to sell corporate assets and distributes them to its stockholders to effect the sale, the corporation is taxable upon the gain."[23]

This example is approximately the case of *Commissioner v. Court Holding Company*[24] and can very well be called double taxation. This example further points up that the gain can be by virtue of advantageous contract, as well as a result of general prosperity. The test to distinguish *General Utilities Co. v. Helvering* is whether or not there was in fact a sale made by the corporation or by the stockholders. The nearer the transaction is to a sale by the corporation the nearer it is to the subjection of demands by the Treasury.

4. The declaring corporation is not subject to tax upon a distribution in kind even though the property has appreciated in value and in spite of terms of the declaration asserting valuation where the distribution yet remains a declaration in kind.[25]

5. Examples 2 and 4 above are subject to the limitation that if the property so distributed is potential income rather than capital assets, the distribution is taxable as an anticipatory assignment of income and is taxable upon receipt and in the amounts received.

This is the holding of the *Stratford Bank* case and this brief example points up the error of the Tax Court in its refusal to admit that the notes were no longer assets. Since the basis of these properties has been reduced to zero by deduction, anything received will be income and an assignment will be an anticipatory assignment of income.

If the courts are strict in their application of the potential income test they may also scrutinize very closely any distributions in kind where basis has been reduced by the taking of deductions, as is illustrated by the case of *Atlas Steamship Co. v. Commissioner*[26] where an assignment to stockholders of insurance proceeds

[23] *Supra*, Note 9, PAUL, 173, citing Macqueen Co. v. Commissioner, 67 F. (2d) 857 (C. C. A. 3rd, 1934). *See also*, Commissioner v. Court Holding Co., 324 U. S. 331 (1944).

[24] Commissioner v. Court Holding Co., *Ibid.*

[25] *Supra*, Note 1.

[26] 18 B. T. A. 654 (1930).