

HVL:rs
695:45,OLC
Op. 56-67

May 21, 1956

Honorable Earl W. Fase
Tax Commissioner
Territory of Hawaii
Honolulu, Hawaii

Dear Sir:

You have requested our opinion as to the application of chapters 98 and 102 in the following type of case:

A corporation, "A," in 1951 causes another corporation, "B," to be formed. "A" transfers real property to "B" in consideration of stock. "A" dissolves and distributes the "B" stock to its stockholders. In 1956, "B" sells the property for a price in excess of the value carried on the books. "B" then dissolves and distributes the sales proceeds among its shareholders. "B's" shareholders, who also were "A's" shareholders, now contend that "B's" book value was lower than the value of the property in 1943 and was lower than the fair market value of the property at the time that "B" corporation was formed in 1951. It is contended that the book value was merely to cost to "A", which was placed on "B's" books because this was a tax free reorganization under the Internal Revenue Code of the United States.

Questions that have arisen are as follows:

1. When "A" dissolved in 1951 and distributed the "B" stock to its stockholders, was this a taxable liquidating dividend?
2. When "B" dissolved in 1956 and distributed the sales proceeds to its shareholders was this a taxable liquidating dividend?

Chapter 98, section 5343, defines "dividends" as follows:

"Dividends" means any distribution whether in money or other property made by a local or foreign company * * * to its shareholders or holders of an interest therein on account of ownership of such shares or interest, out of its earnings or profits, except liquidating dividends paid out of earnings

or profits accumulated, or increase in value of property accrued, before January 1, 1943. Every distribution shall be deemed to have been made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. For the purposes of this paragraph a liquidating dividend shall be deemed to mean a distribution made as part of a plan to cease doing business and to wind up the affairs of the company."

Similarly chapter 102 in section 5501 contains the following:

"'Dividend' means any distribution, whether in money or other property (including a stock dividend except as hereinafter provided), made by a corporation, local or foreign, to its shareholders or holders of an interest therein on account of ownership of such shares or interest, out of its earnings or profits, whenever earned, including distributions in complete or partial liquidation, provided that a distribution made as part of a plan to cease doing business and to wind up the affairs of the corporation, if and to the extent paid out of earnings or profits accumulated, or increase in value of property accrued, before January 1, 1943, shall not be deemed a dividend. Every distribution shall be deemed to have been made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *"

1. When "A" dissolved in 1951 and distributed the "B" stock to its stockholders, was this a taxable liquidating dividend?

The answer to this first question depends upon another. What was the amount of the accumulated earnings and profits of "A" at the time of the distribution of the "B" stock? When stock of another corporation is distributed, the fair market value of that stock determines the amount of the distribution, but it is necessary to inquire further to determine whether the entire distribution is a dividend. Only distributions out of earnings or profits are dividends.

Although "A" is not liable to tax on the capital gains realized by the sale of the property to "B", "A" did realize earnings and profits from that sale. The difference between the cost to "A" and the fair market value of the "B" stock constitutes the earnings and profits, assuming there were no other earnings or profits.

A ceiling upon the taxability of this distribution is provided by the statute. To the extent that the "B" stock is a distribution out of increase in value of the property, transferred to "B", which had accrued before January 1, 1943, the distribution is not taxable since this is a liquidating dividend.

Thus if it be assumed that the property transferred to "B" had not decreased in value between January 1, 1943 and the time of the transfer, the base to be compared with the fair market value of the "B" stock in determining the amount of the distribution which is taxable as a liquidating dividend, is cost to "A" or January 1, 1943 value, whichever is higher.

It appears that no tax returns of liquidating dividends were made, and that the Tax Commission has not made an assessment. Of course if the value of the property transferred to "B" was only that which was placed on "B's" books, the "B" stock would not have a fair market value that would sustain an assessment. When the Tax Commissioner does not attack a book value as too high or too low, others may well be stopped to do so. This would be such a case if the tax year involved was no longer open to assessment. As this is not the case, the fair market value of the "B" stock may be determined and an assessment of liquidating dividends made accordingly.

A further statement is necessary at this point. It has been your past administrative practice to accept a book value in a case like this. Due to difficulties in determining depreciation if revaluation of assets is insisted upon in every case, it may well be that you continue to accept book value in a case like this. However, if the corporation to which the property is transferred itself liquidated wholly or partly, you would then go back over the ground as indicated below in the answer to question 2.

2. When "B" dissolved in 1956 and distributed the sales proceeds to its shareholders was this a taxable liquidating dividend?

The answer to this second question, like the answer to the first, turns upon the amount of the accumulated earnings and profits of "B" at the time of the distribution of the sales proceeds. What were the earnings and profits from the sale? What is "B's" base for the determination of this? The fair market value of the stock issued for the property is the base. But again, the book value of the property was not attacked by the Tax Commissioner and there is a question whether others are estopped to do so. With the year of "A's" liquidating dividend still open, fair

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market value in that year can be reexamined and proper adjustments can be made both as to that year and also as to the year in which "B" liquidates. However if the year in which "A" liquidated were closed, or if "A" and its stockholders could no longer be assessed for any reason, "B" and its stockholders would be estopped to use a base higher than that indicated by the book value of the property or fair market value of the property as of January 1, 1943, whichever is the higher.

Authorities bearing on the above matter are:

Osgood v. Commissioner, 126 N.E. 371; Hornblower v. Commissioner, 180 N.E. 534; Wellman v. Commissioner, 193 N.E. 733, 735 (having to do with the making of a liquidating dividend through distribution of stock); cf. Van Heusen v. Commissioner, 154 N.E. 257 (relating to an amendment of the Massachusetts statute, not contained in the Hawaiian law).

Southern Coach Lines v. McCanless, 235 S.W.2d 804 (relating to estoppel of taxpayer to show base was greater than book value).

3 Mertens Law of Income Taxation, Secs. 21.15 and 21.16 (relating to base in case of transfer of property for stock where not governed by a statutory nonrecognition provision).

State Tax Commission v. Love Petroleum Co., 19 S.2d 923 Miss., 1944 (relating to base for depreciation).

This letter supersedes my letter to you of June 25, 1954.

Respectfully,

RHODA V. LEWIS
Deputy Attorney General