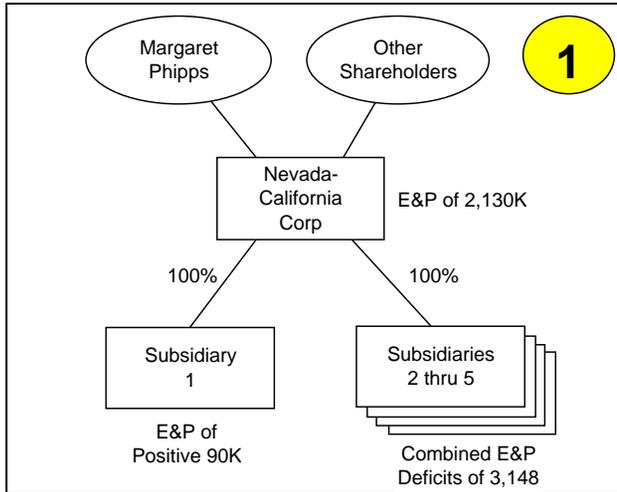


Commissioner v. Phipps
336 U.S. 410 (1949)

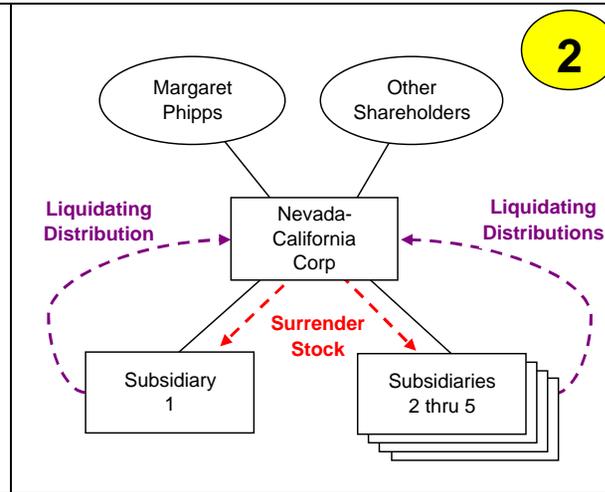
Judicial Creation of
Hovering Deficit Rule

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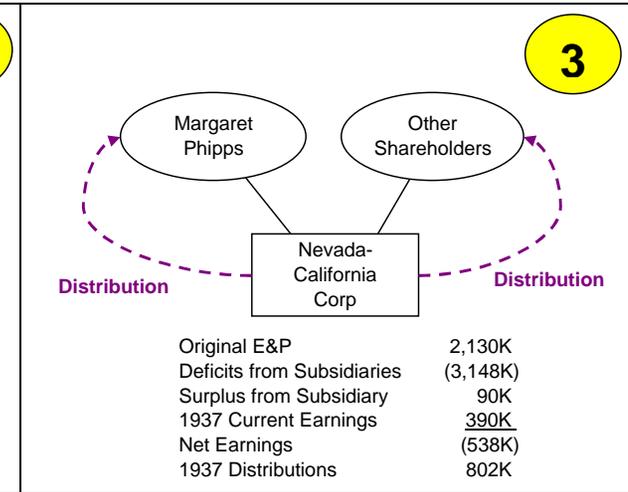
Initial Structure



Liquidations of Subsidiaries (Dec. 1936)



Pro Rata Distributions (1937)



In December 1936, Nevada-California Electric Corporation liquidated five of its wholly owned subsidiaries by distributing to itself all of their assets, subject to their liabilities, and by redeeming and canceling all of their outstanding stock. No gain or loss on the liquidation was recognized for income tax purposes. On the date of liquidation, one of the subsidiaries had earnings and profits, in the amount of \$90,363. The four others had deficits which aggregated \$3,147,804. On December 31, 1936, the parent had earnings and profits, in the amount of \$2,129,958, which amount does not reflect the earnings or deficits of the subsidiaries. In 1937, Nevada-California had current earnings of \$390,387.

Phipps was the owner of 2,640 shares of the preferred stock of Nevada-California. During 1937, that corporation made a pro rata cash distribution to its preferred stockholders in the amount of \$802,284, of which Phipps received \$18,480. The Commissioner determined that the distribution was a dividend and constituted ordinary income in its entirety. Of the 1937 distribution, approximately 49% was chargeable to earnings and profits of the current taxable year. Consequently, Phipps conceded in the Tax Court that that percentage of her share, or about nine thousand dollars, was taxable as a dividend. The Tax Court held in her favor that the balance was not a taxable dividend out of earnings and profits, on the theory that all of Nevada-California's accumulated earnings and profits, plus the accumulated earnings and profits of the subsidiary that had a surplus, were erased by the aggregate deficits of the other four subsidiaries.

In Commissioner v. Sansome, 60 F.2d 931 (2d Cir. 1932), the Second Circuit held: "that a corporate reorganization which results in no 'gain or loss' * * * does not toll the company's life as continued venture * * * , and that what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation." The Supreme Court concluded that the Sansome rule is grounded on the necessity to prevent escape of earnings and profits from taxation. Thus, the Supreme Court stated: "If the assets of the parent and subsidiary are combined via a tax-free reorganization or liquidation, the effect of the Sansome rule is simply this: a distribution of assets that would have been taxable as dividends absent the organization or liquidation does not lose that character by virtue of the tax-free transaction." This rule, often called the "Hovering Deficit Rule," is now included in Code § 381(c)(2)(B). The court also noted that "it has long been a commonplace of tax law that [accounting and taxable income] divergences often occur."