1 T.C. 496 (1943)

A transfer of stock to the issuing corporation is treated as a sale, taxable as a capital gain, rather than a distribution in partial liquidation, if, at the time of the transfer, there was no pre-existing plan or decision by the corporation to retire the stock.

Summary

Hadley, a minority shareholder of A P Parts Corporation (A P), sold his shares back to the corporation. The key issue was whether this transaction constituted a sale of stock, taxable as a capital gain, or a distribution in partial liquidation, taxable as ordinary income. The Tax Court held that it was a sale, focusing on the absence of a pre-existing plan to retire the stock at the time of the sale. The court emphasized that the decision to retire the stock was made after the initial transfer, and the corporation's business was expanding, not contracting, further supporting the characterization of the transaction as a sale. The intent at the time of the transfer is critical.

Facts

Hadley, president of A P but no longer actively managing it, wanted to increase his holdings in another company. He offered to sell his A P stock. A P, through its controlling shareholder, agreed to buy Hadley's shares at book value. Four contracts were drawn up for the sale of different blocks of stock with varying payment schedules. The initial transfer of 90 shares occurred on November 12, 1938. A P held these shares in its treasury temporarily. Later, on November 15, A P's directors decided to retire the stock, which was approved by the stockholders on November 30.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Hadley's income tax for 1938 and 1939, arguing that the gains from the stock transfer were taxable as distributions in partial liquidation. Hadley contested this, claiming the gains should be taxed as capital gains from the sale of stock. The Tax Court heard the case and ruled in favor of Hadley.

Issue(s)

Whether the gains realized by Hadley on the transfer of his A P stock to the corporation should be taxed as distributions in partial liquidation under Section 115(c) and (i) of the Revenue Act of 1938, or as gains from the sale of capital assets under Section 117 of the same act?

Holding

No, the gains are not taxable as distributions in partial liquidation because at the

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time of the stock transfer, there was no definitive plan or intent by the corporation to retire the stock; therefore, the transaction constitutes a sale.

Court’s Reasoning

The court emphasized that while the transaction took the form of a sale and the stock was ultimately retired, the critical factor was the absence of a pre-existing plan to retire the stock at the time of the sale. The court noted that the decision to retire the stock was made *after* Hadley had already transferred the initial 90 shares. The court highlighted that A P’s business was expanding, not contracting, suggesting that the stock transfer was not part of a liquidation plan. The court quoted Alpers v. Commissioner, stating, “The character of the transaction must be judged by what occurred when the petitioner surrendered his certificate in exchange for payment. It is stipulated that his shares were transferred to the corporation but we can see nothing to indicate that when it acquired them it had then the intention to retire them.” The court reasoned that a subsequently formed intention to retire stock does not retroactively convert the purchase price into a distribution in partial liquidation.

Practical Implications

This case clarifies that the timing of the decision to retire stock is crucial in determining whether a stock transfer is treated as a sale or a distribution in partial liquidation. Legal practitioners must carefully examine the sequence of events and the corporation’s intent at the time of the transfer. The Hadley decision highlights the importance of contemporaneous documentation demonstrating the corporation’s plan (or lack thereof) regarding the stock at the time of repurchase. The expanding or contracting nature of the business provides strong evidence of the purpose of the transaction. Later cases will distinguish Hadley if a clear plan to retire stock existed at the time of the transfer, even if the formal steps for retirement were taken later.

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