2 T.C. 111 (1943)

A stock redemption can be deemed equivalent to a taxable dividend if the distribution doesn't significantly alter the shareholder's control or the corporation's business operations and primarily serves to distribute accumulated earnings.

Summary

United National Corporation (UNC), the sole stockholder of Murphey, Favre & Co. (Murphey Co.), surrendered 750 of its 1,000 shares in Murphey Co. for cancellation. UNC received cash and securities. The Commissioner of Internal Revenue argued that this distribution was essentially equivalent to a taxable dividend under Section 115(g) of the Revenue Act of 1938. The Tax Court agreed with the Commissioner, finding that the redemption served primarily to distribute earnings, not to genuinely liquidate a portion of the business or alter control significantly. Furthermore, the court held that previously realized gains from preferred stock redemption should be included when calculating accumulated earnings and profits.

Facts

UNC was a holding company that owned all the stock of Murphey Co.
In 1938, UNC surrendered 750 of its 1,000 shares of Murphey Co. stock for cancellation, receiving cash and securities worth $176,746.55.
Immediately after the redemption, UNC sold its remaining 250 shares to Murphey Co. officers.
Prior to the redemption, officers of Murphey Co. negotiated to purchase all shares of the company but were unable to raise enough funds based on Murphey Co.'s capitalization.
Murphey Co. had substantial accumulated earnings and profits. The purpose of the redemption was to facilitate UNC selling its remaining shares.

Procedural History

The Commissioner determined a deficiency in UNC's income tax, arguing the stock redemption was equivalent to a taxable dividend.
UNC petitioned the Tax Court, claiming the distribution was a partial liquidation and not taxable as a dividend.</r

Issue(s)

1. Whether the redemption of 750 shares of Murphey Co. stock was essentially equivalent to the distribution of a taxable dividend under Section 115(g) of the Revenue Act of 1938.
2. Whether the gain realized by Murphey Co. upon the redemption of its preferred stock should be included in the calculation of accumulated earnings and profits for the purpose of Section 115(g).

© 2025 SCOTUSreports.com. All rights reserved.

Holding

1. Yes, because the redemption did not significantly alter the shareholder's control or the corporation's business operations and primarily served to distribute accumulated earnings, it was essentially equivalent to a dividend.
2. Yes, because the gain realized from the redemption of preferred stock constitutes part of the company's accumulated earnings or profits.

Court's Reasoning

The court reasoned that the redemption allowed UNC to receive a substantial portion of Murphey Co.'s net worth without a formal dividend declaration, while also enabling the sale of the remaining shares. The court emphasized that the Murphey Co.'s business operations continued profitably after the redemption, indicating that the reduction in capital stock was not related to a decrease in business activity.
The court noted that the directors' resolution explicitly provided for the distribution to include a portion of the earned surplus. The court also cited *George Hyman, 28 B.T.A. 1231*, finding that the UNC, as the sole stockholder of a corporation with substantial surplus received an amount greater than the adjusted earned surplus.
The court stated, "From such facts it is just as conceivable that the redemption and cancellation were essentially equivalent to a dividend as it is that they were not; and, since the respondent has determined that they were, and the burden of proof is on petitioner, we cannot affirmatively find that it was not."
Regarding the inclusion of gains from preferred stock redemption in accumulated earnings, the court stated, "[M]any items such as interest upon the obligations of a state and dividends from other corporations 'must necessarily be considered in computing earnings and profits, though forming no part of taxable net income.'" Therefore, even tax-free profits contribute to the earnings available for distribution.

Practical Implications

This case illustrates that stock redemptions, particularly in closely held corporations, are subject to close scrutiny by the IRS. Attorneys must advise clients that redemptions that lack a genuine business purpose and primarily distribute accumulated earnings may be recharacterized as taxable dividends. The presence of accumulated earnings, a pro rata distribution, and the absence of a significant change in corporate control are factors that increase the likelihood of dividend equivalence. It is important to document a legitimate business purpose for the redemption from the perspective of the corporation, not just the shareholder. Further, this case confirms that all earnings, even those not subject to income tax, may be included in the calculation of accumulated earnings and profits when determining dividend equivalence under Section 115(g) (now Section 302 of the Internal Revenue Code).

© 2025 SCOTUSreports.com. All rights reserved.