4 T.C. 854

When a corporation redeems its stock with the intent to cancel and retire it, the distribution to the shareholder is considered a partial liquidation and is taxed as ordinary income, not as a capital gain from a sale, regardless of the terminology used in the transaction documents.

Summary

George F. Jones contested a tax deficiency, arguing that the proceeds from the redemption of his stock in Billings Dental Supply Co. should be taxed as capital gains from a sale, not as ordinary income from a partial liquidation. Jones sold his shares back to Billings, which subsequently canceled the stock. The Tax Court held that because Billings intended to retire the stock, the transaction constituted a partial liquidation under Section 115(c) of the Internal Revenue Code, and the gain was taxable as ordinary income. The court emphasized that the corporation's intent, not the terminology used by the parties, determines the nature of the distribution for tax purposes. The court also addressed the basis of stock acquired as a stock dividend, affirming the necessity of basis allocation.

Facts

Petitioner George F. Jones owned stock in Billings Dental Supply Co. (Billings).
In 1940, Billings decided to sell its supply business and reorganize, reducing its capital stock.
Jones, desiring to withdraw from the company due to the sale, agreed to sell his 331 shares back to Billings.
The agreement referred to a "sale" and "purchase" of stock at $110 per share.
Billings acquired 486 shares in total from various stockholders at the same time, including Jones's shares.
Billings canceled 411 of these shares, including all of Jones's, and reissued 75 shares.
At a special meeting, stockholders approved the "purchase and retirement" of these shares.
Jones argued he sold his stock and should be taxed at capital gains rates.

Procedural History

George F. Jones petitioned the United States Tax Court contesting a deficiency in income tax for the calendar year 1940 as determined by the Commissioner of Internal Revenue.

Issue(s)

1. Whether the gain realized by petitioner from the disposition of his corporate stock is taxable under Section 115(c) of the Internal Revenue Code as a distribution in partial liquidation, or under Section 117 as a gain from the sale

of capital assets.
2. Whether the basis of stock acquired as a stock dividend, part of which was redeemed in a prior year and taxed as an ordinary dividend, should be fully included in the basis of remaining shares when calculating gain upon a later disposition.

Holding

1. Yes, the gain is taxable as a distribution in partial liquidation because the corporation intended to cancel and retire the stock, making Section 115(c) applicable, regardless of the "sale" terminology used.
2. No, the basis of the stock redeemed in the prior year should not be included. The basis of stock acquired as a stock dividend must be allocated between the original stock and the dividend stock, and the basis of shares already disposed of cannot be retroactively added to remaining shares.

Court's Reasoning

The court reasoned that the terminology of "sale" and "purchase" is not determinative; the crucial factor is the corporation's intent. Citing *Kena, Inc.*, the court stated, "The use by the parties of the terms 'purchase' and 'sale' does not determine the character of the transaction."

The court emphasized that Section 115(i) defines partial liquidation as "a distribution by a corporation in complete cancellation or redemption of a part of its stock." The intent of the corporation to cancel and retire the stock is the controlling factor, citing *Hammans v. Commissioner* and *Cohen Trust v. Commissioner*.

The minutes of the stockholders' meeting explicitly stated the "purchase and retirement" of the stock, indicating the corporation's intent to cancel the shares. The court found no evidence that Billings intended to hold the stock as treasury stock for resale.

Regarding the stock basis issue, the court referred to Section 113(a)(19) of the Internal Revenue Code, which mandates the allocation of basis between old stock and new stock acquired as a stock dividend. The court rejected the petitioner's argument that because the 1932 redemption was treated as an ordinary dividend, the basis of those shares should be added to the remaining shares. The court clarified that the purpose of Section 113(a)(19) is to ensure fair tax recovery of the original cost basis, and the Commissioner correctly applied the allocated basis.

Practical Implications

Jones v. Commissioner clarifies that the tax treatment of stock redemptions hinges on the corporation's intent to retire the stock, not merely the language used in transaction documents. This case emphasizes the importance of examining the substance over the form of corporate transactions for tax purposes.

For legal practitioners, this case serves as a reminder that when advising clients on stock redemptions, it is critical to ascertain and document the corporation's intent regarding the redeemed shares. If the intent is retirement, partial liquidation treatment under Section 115(c) is likely to apply, leading to ordinary income tax rates. This case also reinforces the principle of basis allocation for stock dividends, impacting how gains are calculated on subsequent stock dispositions. Later cases and IRS rulings continue to apply the principle that corporate intent dictates the classification of stock redemptions, making *Jones* a foundational case in this area of tax law.