***Meyer v. Commissioner of Internal Revenue*, 5 T.C. 165 (1945)**

When a corporation redeems stock from its sole shareholder at a time and in a manner that is essentially equivalent to a dividend distribution, the redemption proceeds are taxed as ordinary income, not capital gains, even if the stock was originally issued for property.

**Summary**

Bertram Meyer, the sole shareholder of Bersel Realty Co., received cash from the company's redemption of his noncumulative preferred stock over four years. The Tax Court determined that these redemptions, made out of corporate earnings, were essentially equivalent to taxable dividends under Section 115(g) of the Revenue Act of 1938 and the Internal Revenue Code. The court emphasized that the 'net effect' of the distribution, rather than the taxpayer's intent, is the determining factor. Even though the stock was originally issued for property, and the corporation had a history of stock redemptions, the consistent pattern of distributions to the sole shareholder, coinciding with corporate earnings, indicated a dividend equivalent. The court upheld the Commissioner's deficiency assessment, treating the redemption proceeds as ordinary income.

**Facts**

Petitioner, Bertram Meyer, formed Bersel Realty Co. and transferred real estate and leases in exchange for preferred and common stock. He received 13,500 shares of 5% noncumulative preferred stock. Meyer initially intended to invest only $1,000,000 in capital, but accountants advised issuing more preferred stock ($1,850,000) instead of classifying the excess as corporate debt to Meyer. A company resolution restricted dividends on noncumulative preferred and common stock until cumulative preferred stock was retired and noncumulative preferred stock was reduced to $1,000,000. From 1938 to 1941, Bersel Realty Co. redeemed portions of Meyer's noncumulative preferred stock, totaling $125,000, while the company had substantial earnings and profits during those years. No dividends were ever paid on noncumulative preferred or common stock.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in Meyer's income tax for 1938-1941, arguing the stock redemptions were taxable dividends. Meyer contested this, arguing the redemptions were not dividend equivalents. The Tax Court reviewed the Commissioner's determination.

**Issue(s)**

1. Whether the redemption of noncumulative preferred stock by Bersel Realty Co. during 1938-1941, from its sole shareholder, Bertram Meyer, was 'at such time and in such manner as to make the distribution and cancellation or redemption

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in whole or in part essentially equivalent to the distribution of a taxable dividend' under Section 115(g) of the Revenue Act of 1938 and the Internal Revenue Code.
2. Whether Bersel Realty Co. had sufficient earnings or profits accumulated after February 28, 1913, to support dividend treatment of the stock redemptions.

**Holding**

1. Yes, because the redemptions were made at a time and in a manner that rendered them essentially equivalent to taxable dividends.
2. Yes, because Bersel Realty Co. had earnings available for dividend distribution during each of the years 1938-1941, exceeding the redemption amounts.

**Court's Reasoning**

The Tax Court focused on the 'net effect' of the stock redemptions, citing *Flanagan v. Helvering*, stating, "The basic criterion for the application of Section 115 (g) is 'the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation.'" The court dismissed Meyer's argument that the stock was bona fide issued for property, stating, "We consider it immaterial whether, as petitioner contends, the preferred stock was issued bona fide and for property of a value equal to the par value of the shares issued therefor. The important consideration is that under its plan the corporation could, by redeeming shares of that stock from year to year, distribute all of its earnings tax-free to its sole stockholder." The court noted that the corporation had substantial earnings during the redemption years and that the redemptions allowed Meyer, the sole shareholder, to receive corporate earnings without traditional dividends. The court distinguished *Patty v. Helvering*, which Meyer cited, arguing that the Second Circuit's view in *Patty* was too broad and that all circumstances of redemption must be considered. The dissent argued that the redemptions were a return of capital, aligning with Meyer's original intent not to overcapitalize the company, and likened it to repaying a loan, suggesting Section 115(g) should not apply. However, the majority emphasized the statutory language and the practical outcome of the distributions.

**Practical Implications**

*Meyer v. Commissioner* clarifies that the tax treatment of stock redemptions hinges on the 'net effect' of the distribution, not just the initial purpose or form of the transaction. It highlights that regular stock redemptions, especially in closely held corporations with substantial earnings and a sole shareholder, are highly susceptible to being recharacterized as taxable dividends, even if the redeemed stock was originally issued for property. This case emphasizes that businesses must carefully structure stock redemptions to avoid dividend equivalence, particularly when distributions are pro-rata or primarily benefit controlling shareholders and coincide with corporate earnings. Later cases applying Section 302 (the successor to 115(g)) continue to use a similar 'net effect' test, focusing on whether the redemption

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meaningfully reduces the shareholder’s proportionate interest in the corporation. This case serves as a cautionary example for tax planners to consider the broader economic substance of stock transactions to avoid unintended dividend tax consequences.

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