A.J. Tower Co. v. Commissioner, 3 T.C. 96 (1944)

When a corporation acquires its own stock, the tax treatment (as a partial liquidation or as a simple purchase) depends on whether the primary intent was cancellation/retirement of the stock or holding it for potential reissuance.

Summary

The A.J. Tower Co. purchased 750 shares of its preferred stock from a shareholder. The central issue was whether this transaction constituted a partial liquidation, which would require the shareholder to recognize 100% of the gain as a short-term capital gain under the then-current tax law, or a simple purchase of stock, where only 50% of the gain would be recognized due to the shareholder's long-term holding period. The Tax Court determined that the purchase was part of a long-term plan to cancel and retire the preferred stock, making it a partial liquidation. The court emphasized the company's consistent practice of retiring purchased shares and the broader context of a plan to gradually eliminate trust ownership in the company.

Facts

The A.J. Tower Co. reorganized in 1926 with the specific purpose of gradually transferring ownership from a trust to the trust's beneficiaries.
As part of this reorganization, 10,000 shares of preferred stock were issued to the trust.
The company was obligated to set aside $50,000 annually to acquire and cancel 500 shares of preferred stock through a sinking fund.
In 1941, the company purchased 750 shares of its preferred stock from the petitioner.
These shares were initially recorded as "treasury stock" and were formally canceled in 1942.
The company declared two dividends on its common stock in 1941, which it could not legally do if it hadn't met its sinking fund requirements.

Procedural History

The Commissioner of Internal Revenue determined that the sale of stock constituted a partial liquidation.
The A.J. Tower Co. petitioned the Tax Court for a redetermination of the deficiency.
The Tax Court ruled in favor of the Commissioner.

Issue(s)

Whether the purchase of the 750 shares of preferred stock by the A.J. Tower Co. from the petitioner in 1941 constituted a distribution in partial liquidation under the applicable tax law, or an ordinary purchase of its own stock.

Holding

No, because the purchase was made as part of a long-standing plan to acquire and retire all of the company's preferred stock, indicating a partial liquidation rather than a simple purchase for potential reissuance.

Court's Reasoning

The court distinguished between cases where a corporation buys its stock for cancellation/retirement (partial liquidation) and those where it holds the stock as a treasury asset for potential reissuance (ordinary purchase).
The court emphasized the original intent of the 1926 reorganization plan, which included a sinking fund to systematically retire the preferred stock.
The court noted the company's obligation to purchase shares for the sinking fund in 1941 and reasoned that the purchase of the 750 shares was likely intended to fulfill or exceed this obligation.
The fact that the shares were initially carried as "treasury stock" was deemed insignificant compared to the broader context of the company's historical practice of retiring purchased shares. The court stated, "It seems to us that it would be wholly unrealistic, in the face of all the evidence which is in the record, to hold that the particular 750 shares purchased in 1941 were purchased for the purpose of resale and reissue to future stockholders."
The court acknowledged the president's testimony about potentially needing the stock for government contracts but concluded that the primary intent was still ultimate cancellation and retirement.

Practical Implications

This case highlights the importance of examining the intent and context behind a corporation's purchase of its own stock to determine the correct tax treatment.
Legal practitioners must consider the company's history, its stated plans, and its actual practices in assessing whether a purchase is a partial liquidation or a simple stock purchase.
The case emphasizes that even if a corporation temporarily holds purchased stock as "treasury stock," the ultimate intent to cancel and retire the shares can still lead to a determination of partial liquidation.
This decision influenced later cases by reinforcing the focus on the corporation's underlying purpose in acquiring its own shares. It underscores that the mere form of the transaction (e.g., holding shares as treasury stock) is not determinative; the substance of the transaction, as evidenced by the surrounding circumstances, controls.

