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

When a corporation acquires its own stock, the key factor in determining whether it's a partial liquidation (taxed as short-term capital gain) or a simple stock purchase (taxed as long-term capital gain if held long enough) is the corporation's intent: whether the stock was acquired for cancellation/retirement or to be held as treasury stock for potential reissue.

Summary

A.J. Tower Co. purchased 750 shares of its preferred stock from a trust. The central issue was whether this transaction qualified as a partial liquidation under tax law, requiring the gain to be treated as a short-term capital gain, or as a simple purchase of stock, allowing for treatment as a long-term capital gain. The Tax Court ruled that, based on the company's history of purchasing and retiring preferred stock under a pre-existing plan to reduce trust ownership, the purchase constituted a partial liquidation, regardless of the company temporarily holding the stock as "treasury stock." The court emphasized the overarching intent behind the stock acquisition.

Facts

- A.J. Tower Co. had a reorganization plan since 1926 to gradually shift ownership from a trust to trust beneficiaries.
- The plan involved issuing 10,000 shares of preferred stock to the trust and a sinking fund provision, requiring the company to set aside $50,000 annually to acquire and cancel 500 shares of preferred stock after 1928.
- On July 2, 1941, the company purchased 750 shares of its preferred stock from the petitioner (trust).
- The shares were initially recorded as "treasury stock" but were mostly transferred to the sinking fund and ultimately canceled in 1942.
- The company declared two dividends on its common stock in 1941.

Procedural History

The Commissioner of Internal Revenue determined that the sale of stock was a partial liquidation, taxable as short-term capital gain. The A.J. Tower Co. petitioned the Tax Court for review of this determination. The Tax Court sustained the Commissioner's determination.

Issue(s)

Whether the acquisition of 750 shares of preferred stock by A.J. Tower Co. from the petitioner in 1941 constituted a distribution in partial liquidation of the company, or an ordinary purchase of stock for holding as treasury stock?

Holding

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No, the acquisition was a partial liquidation because the company's primary intent, supported by its history and reorganization plan, was the ultimate cancellation and retirement of the shares, not their reissue as treasury stock.

Court's Reasoning

The court emphasized the importance of determining the corporation's intent. It noted the 1926 reorganization plan aimed to reduce trust ownership by gradually purchasing and retiring the preferred stock. The sinking fund provision mandated the purchase of 500 shares annually for cancellation. The court reasoned that the purchase of 750 shares in 1941 was part of this ongoing plan, regardless of the temporary designation as "treasury stock." The court noted that dividends were declared on common stock, implying that the sinking fund requirements were intended to be met. While the company president testified that holding the stock as treasury stock offered potential financial flexibility for government contracts, the court considered this a secondary consideration. The court stated, "the primary and controlling purpose of the board of directors in directing the purchase of the 750 shares in question was for the ultimate cancellation and retirement of the shares, either through the sinking fund or otherwise." The consistent history of purchasing and retiring preferred shares without reissue further supported this conclusion.

Practical Implications

This case illustrates that the tax treatment of a corporation's acquisition of its own stock hinges on the corporation's underlying intent. Subsequent actions, like holding the stock as "treasury stock," are less important than the overarching plan. Tax advisors must thoroughly investigate the history and documentation surrounding such transactions to accurately determine the tax implications. Corporations must carefully document their intent when repurchasing their own shares to support their desired tax treatment. This case also highlights that a long-term plan to liquidate stock will be considered when determining tax status, even if the short-term behavior doesn't perfectly align with that plan. Later cases will look to the facts and circumstances to determine intent, and the presence of a formal plan greatly increases the likelihood of a finding of partial liquidation.

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