8 T.C. 322 (1947)

Distributions by a mutual investment company upon redemption of its stock, which include a share of current net earnings, are considered preferential dividends and are not eligible for the basic surtax credit under Section 27(b)(1) of the Internal Revenue Code, due to restrictions imposed by Section 27(h).

Summary

New York Stocks, Inc., a mutual investment company, redeemed its stock at stockholders' requests throughout the taxable year, paying the net asset value for the redeemed stock. The net asset value included a share of the company's current net earnings up to the redemption date. The company claimed a surtax credit for these earnings paid out upon redemption in addition to a surtax credit for ordinary dividends. The Tax Court held that these distributions were preferential dividends under Section 27(h) of the Internal Revenue Code and, therefore, not includible in the amount of dividends paid for the basic surtax credit under Section 27(b)(1).

Facts

New York Stocks, Inc. was an open-end mutual investment company issuing multiple series of special stock. Proceeds from each series were invested in specific industry sectors. Stockholders had the option to redeem their shares at any time for the net asset value, less a small redemption charge. The net asset value included the stockholder's proportionate share of the series' net earnings up to the redemption date. During the tax year, the company redeemed shares for an aggregate sum of $5,717,989.76, which included $40,932.69 of net earnings up to the redemption date.

Procedural History

The Commissioner of Internal Revenue disallowed a portion of New York Stocks, Inc.'s claimed basic surtax credit. The Tax Court heard the case to determine whether the $40,932.69 in earnings distributed upon redemption of stock qualified for the basic surtax credit. The Tax Court ruled in favor of the Commissioner.

Issue(s)

Whether a mutual investment company is entitled to include the amount of its current net earnings distributed upon the redemption of stock in the amount of dividends paid for purposes of the basic surtax credit under Section 27(b)(1) of the Internal Revenue Code, given the restrictions imposed by Section 27(h) regarding preferential dividends.

Holding

No, because the distributions were deemed to be preferential dividends under

Section 27(h) of the Internal Revenue Code. These distributions did not qualify for the basic surtax credit under Section 27(b)(1).

Court's Reasoning

The court reasoned that while mutual investment companies could treat the distribution of earnings as taxable dividends to shareholders for purposes of meeting the 90% distribution requirement under Section 361(a)(4), this did not exempt them from the general restrictions of Section 27(h) regarding preferential dividends. The court relied on *May Hosiery Mills, Inc.*, which established that distributions on the redemption of stock are preferential if there is no plan for redeeming all shares of a class or a proportionate amount from each stockholder on the same terms and during a definite period. The court found that because New York Stocks, Inc. redeemed shares only when stockholders chose to exercise their option, the distributions were preferential. The court stated, "The restriction in Section 27(h) against preferential dividends applies to distributions in liquidation on redemption of stock as well as to ordinary dividend distributions." The court distinguished *United Artists Theatre Circuit, Inc.*, where all preferred stock of a class was retired under a plan of recapitalization.

Practical Implications

This case clarifies that mutual investment companies must adhere to the preferential dividend restrictions when calculating the basic surtax credit, even if the distributed earnings qualify as taxable dividends for other purposes. It reinforces the principle that ad hoc redemptions of stock, based solely on stockholder option, are likely to be treated as preferential distributions. Legal practitioners advising mutual investment companies must ensure that redemption plans are structured to avoid preferential treatment to maintain eligibility for the basic surtax credit. Later cases have cited this ruling to support the disallowance of dividends-paid credits where distributions were not pro rata across all shareholders or classes of stock.