13 T.C. 884 (1949)

Distributions of net earnings by a regulated investment company upon the redemption of its shares are not considered preferential dividends and can be included as dividends paid when calculating the basic surtax credit.

Summary

National Securities Series, an open-end investment trust, redeemed shares and distributed net earnings to shareholders. It then included these distributions as dividends paid for its basic surtax credit. The Commissioner of Internal Revenue argued that these distributions were preferential dividends, disqualifying them for the surtax credit. The Tax Court held that the distributions were not preferential dividends because all shareholders had an equal opportunity to redeem their shares, and the method provided an intrinsically fair way of distributing earnings. Therefore, the company could include the distributions as dividends paid when calculating its basic surtax credit.

Facts

Each petitioner was a regulated investment company, holding property in trust and investing in securities. The petitioners regularly issued certificates representing shares in the trust property and redeemed these certificates under the provisions of their trust agreement. As open-end investment companies, shareholders could surrender their shares for redemption at any time, receiving a proportionate share of the assets, including net income received to the date of surrender. During the tax year, petitioners redeemed shares and paid surrendering shareholders their share of assets and net income. Petitioners treated these payments as dividends paid when computing their basic surtax credit.

Procedural History

The Commissioner of Internal Revenue determined that the distributions were preferential dividends and could not be treated as dividends paid for computing the basic surtax credit. The Tax Court, however, reversed its original stance based on the Second Circuit’s decision in *New York Stocks, Inc. v. Commissioner*, which addressed the same issue. The cases were consolidated for trial and opinion in the Tax Court.

Issue(s)

Whether earnings paid to shareholders upon the redemption of shares are preferential dividends under Section 27(h) of the Internal Revenue Code, thus not includible as dividends paid when computing the basic surtax credit under Sections 362(b) and 27(b)(1) of the Code.

Holding

No, because the distributions were made available in conformity with the rights of each stockholder, where no act of injustice to any stockholder was contemplated or perpetrated, where there was no suggestion of a tax avoidance scheme, and where each stockholder was treated with absolute impartiality, the distribution is not preferential within the meaning of the statute.

Court's Reasoning

The court relied heavily on the Second Circuit's decision in *New York Stocks, Inc. v. Commissioner*, which reversed the Tax Court's prior ruling on the same issue. The Second Circuit held that distributions by an open-end trust to stockholders upon redemption of shares, representing earnings up to the date of redemption, were not preferential dividends under Section 27(h). The court emphasized that it was impossible to require the company to declare a complete dividend every time a share was redeemed. The court also cited a report from the House Committee on Ways and Means, stating that no distribution should be considered preferential if it treats shareholders with substantial impartiality and consistently with their stockholding interests. The court reasoned that each shareholder had an equal opportunity to redeem, and the method used provided an intrinsically fair distribution of earnings.

Practical Implications

This decision clarifies that regulated investment companies can include distributions made upon stock redemptions when calculating their basic surtax credit, provided that all shareholders have an equal opportunity to redeem their shares and the distributions are made without preference. This ruling is important for investment companies as it allows them to take full advantage of tax benefits intended by Congress. This case and the Second Circuit's decision in *New York Stocks, Inc.* establish a precedent for treating distributions upon stock redemption as non-preferential, influencing how similar cases are analyzed and ensuring fair tax treatment for regulated investment companies and their shareholders. Later cases would distinguish situations where redemption opportunities were not equally available to all shareholders or were part of a tax avoidance scheme.