14 T.C. 255 (1950)

A distribution of corporate surplus to shareholders is considered a taxable dividend when shareholders have the option to receive cash or stock, or when the distribution disproportionately alters shareholders' interests.

Summary

Lester Lumber Company distributed its surplus to stockholders' accounts, who then used the credits to purchase newly issued stock. The Tax Court addressed whether this was a tax-free stock dividend or a taxable cash dividend reinvested in stock. The court found the distribution taxable because at least one shareholder had the option to take cash, and because the distribution disproportionately benefitted some shareholders over others. Additionally, the court upheld a negligence penalty against one shareholder who failed to report interest income and capital gains.

Facts

Lester Lumber Co. had a surplus of $94,268.54. The company's stock was closely held by the Lester family and key employees. Each stockholder had an open account with the corporation where salaries, dividends, and interest were credited, and withdrawals were charged. At an annual meeting, stockholders agreed to distribute the surplus pro rata to their accounts and issue new stock charged against these accounts. However, the distribution was not entirely pro rata; one shareholder, George T. Lester, Sr., directed that part of his share be allotted to another shareholder.

Procedural History

The Commissioner of Internal Revenue determined income tax deficiencies against the individual shareholders, arguing that the distribution of surplus constituted a taxable dividend. Lester Lumber Co. also faced a deficiency notice related to its excess profits credit. The cases were consolidated in the Tax Court, which upheld the Commissioner's determination regarding the individual shareholders, but ruled in favor of Lester Lumber Co. on the excess profits credit issue.

Issue(s)

1. Whether the distribution of the corporation's surplus to its stockholders, who then used the credit to purchase newly issued stock, constitutes a taxable dividend or a non-taxable stock dividend?

2. Whether the 5% negligence penalty was properly imposed on George T. Lester, Sr., for failing to report interest income and capital gains on his tax return?

Holding

1. No, because at least one shareholder had the option to receive cash or direct his share of the surplus to another shareholder, and the distribution disproportionately altered the stockholders' proportionate interests.

2. Yes, because George T. Lester, Sr., was aware of the interest credited to his account and did not provide sufficient explanation for its omission, thus demonstrating negligence.

Court's Reasoning

The court reasoned that even if the stockholders agreed to use their share of the surplus to purchase stock, George T. Lester, Sr.'s ability to direct part of his share to another stockholder and retain a portion as an open credit indicated that he had an election to receive cash or other property. According to the court, "Whenever a distribution by a corporation is, at the election of any of the shareholders * * *, payable either (A) in its stock * * *, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property * * *, then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid." Furthermore, because Lester, Sr., was able to control the distribution, all stockholders had this right, as a corporation cannot discriminate between stockholders. The court also noted the absence of a formal declaration of a stock dividend and the fact that the corporate minutes stated the stock was sold for cash. As for the negligence penalty, the court found Lester, Sr.'s explanation insufficient, noting that his awareness of the interest income coupled with its omission from his return constituted negligence.

Practical Implications

This case clarifies the importance of properly structuring stock dividends to avoid unintended tax consequences. It underscores that even if a distribution is ostensibly intended as a stock dividend, the distribution will be taxed as an ordinary dividend if any shareholder has the option to receive cash or other property instead of stock, or if the distribution changes the shareholders' proportional interests in the corporation. It also highlights the individual's responsibility to accurately report all income, even when relying on a professional to prepare tax returns. Tax advisors should carefully document the intent and mechanics of such transactions to ensure compliance with tax law. Later cases have cited Lester Lumber for the principle that shareholder choice in the form of dividend payment can render the entire distribution taxable.

