Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954)

A stock redemption, even if it would otherwise be considered essentially equivalent to a dividend, will be treated as a sale of stock if the redemption results in a complete termination of the shareholder's interest in the corporation.

Summary

The taxpayer, Mrs. Zenz, sold part of her stock to a third party and then had the corporation redeem the remaining shares. The IRS argued that the redemption was essentially equivalent to a dividend and should be taxed as ordinary income. The Sixth Circuit disagreed, holding that because the redemption resulted in the complete termination of Mrs. Zenz's interest in the corporation, it should be treated as a sale of stock, resulting in capital gains treatment. The court emphasized the importance of the ultimate result of the transaction rather than focusing solely on its individual steps.

Facts

Mrs. Zenz owned all the stock of a corporation. She sold a portion of her shares to a third party. Shortly thereafter, the corporation redeemed the remaining shares she held. The net effect of the sale and redemption was that Mrs. Zenz no longer held any stock in the corporation.

Procedural History

The Commissioner of Internal Revenue determined that the redemption of Mrs. Zenz's stock was essentially equivalent to a dividend and assessed a deficiency. The district court upheld the Commissioner's determination. Mrs. Zenz appealed to the Sixth Circuit Court of Appeals.

Issue(s)

Whether the redemption of stock, which is part of a plan to terminate a shareholder's interest in a corporation, should be treated as a dividend or as a sale of stock for tax purposes.

Holding

No, because the redemption resulted in a complete termination of the shareholder's interest in the corporation, it is treated as a sale of stock, even if the redemption, standing alone, might resemble a dividend. The court looked to the overall result of the transaction.

Court's Reasoning

The court reasoned that the key factor was that Mrs. Zenz completely terminated

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her ownership interest in the corporation. Even though a stock redemption might resemble a dividend distribution in some ways, the critical point is that after the redemption, Mrs. Zenz had no further connection to the company as a shareholder. The court rejected the argument that the redemption should be viewed in isolation from the sale to the third party. Instead, it focused on the overall plan. The court stated that "the question is whether the distribution was 'essentially equivalent to the distribution of a taxable dividend' and, if so, the amount so distributed shall be treated as a taxable dividend." The court determined the distribution was not essentially equivalent to a dividend because of the complete termination of interest.

Practical Implications

The *Zenz* case established the "*Zenz* rule," which provides that if a stock redemption results in a complete termination of a shareholder's interest in a corporation, the redemption will be treated as a sale of stock, regardless of whether the redemption would otherwise be considered essentially equivalent to a dividend. This rule is crucial for tax planning when shareholders wish to exit a corporation. It allows them to receive capital gains treatment rather than ordinary income treatment. Later cases have relied on the *Zenz* rule to determine whether a redemption qualifies for sale treatment. The IRS has acquiesced in the *Zenz* decision, recognizing its validity as a planning tool. This case highlights the importance of considering the overall plan when analyzing the tax consequences of a series of related transactions.

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