18 T.C. 164 (1952)

A stock dividend, issued pursuant to a prearranged plan to immediately sell the dividend shares to a third party, can be treated as the equivalent of a cash dividend and taxed as ordinary income, especially when the purpose is to distribute corporate earnings while avoiding individual income tax rates.

Summary

Petitioners, shareholders of Metal Mouldings Corporation, received a pro rata dividend of newly issued preferred stock on their common stock. Simultaneously, pursuant to a prearranged plan, they sold the preferred stock to insurance companies. The Tax Court held that this dividend was the equivalent of a cash dividend and taxable as ordinary income, not as a capital gain. The court reasoned that the series of transactions was designed to allow the shareholders to extract corporate earnings while avoiding higher individual income tax rates, and the preferred stock's issuance and sale altered the shareholders' proportional interests.

Facts

Metal Mouldings Corporation had a substantial accumulated earned surplus. The controlling shareholder, C.P. Chamberlin, sought a way to distribute the surplus without incurring high individual income tax rates. A plan was devised to issue a preferred stock dividend, which the shareholders would then sell to insurance companies. The terms of the preferred stock were dictated by the insurance companies. The company amended its charter to authorize the preferred stock. Immediately after receiving the preferred stock dividend, the shareholders sold their shares to two insurance companies under a prearranged agreement.

Procedural History

The Commissioner of Internal Revenue determined that the value of the preferred stock received constituted a dividend taxable as ordinary income. The taxpayers argued that the distribution was a stock dividend under Strassburger v. Commissioner and therefore not taxable. The Tax Court ruled against the taxpayers, finding that the dividend was the equivalent of a cash distribution.

Issue(s)

Whether the distribution of preferred stock, followed by a prearranged sale of that stock to third parties, constitutes a taxable dividend equivalent to a cash distribution.

Holding

Yes, because the distribution of preferred stock and the immediate sale were part of a prearranged plan to distribute corporate earnings while avoiding individual

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income tax rates, and it resulted in an alteration of the shareholders' proportional interests in the corporation.

Court's Reasoning

The court distinguished this case from Strassburger v. Commissioner, emphasizing that the substance of the transaction, rather than its form, should control. The court noted that the corporation had sufficient earnings to distribute a cash dividend but chose to issue preferred stock to facilitate the sale to the insurance companies. The court emphasized the prearranged nature of the plan, the insurance companies' involvement in setting the terms of the preferred stock, and the shareholders' intent to receive cash while avoiding ordinary income tax rates. The court stated, "The real purpose of the issuance of the preferred shares was concurrently to place them in the hands of others not then stockholders of the Metal Company, thereby substantially altering the common stockholders' preexisting proportionate interests in the corporation's net assets and thereby creating an entirely new relationship amongst all the stockholders and the corporation." Judge Opper concurred, stating, "not the fact but the possibility of such a sale as took place here is what made this dividend taxable." Judge Arundell dissented, arguing that the intent and action of the corporation in declaring a stock dividend should be controlling.

Practical Implications

This case illustrates the importance of analyzing the substance of a transaction over its form, particularly in tax law. It establishes that a stock dividend, which might otherwise be considered a non-taxable event, can be treated as a taxable dividend if it is part of a plan to distribute corporate earnings while avoiding taxes. This case also demonstrates the importance of considering the business purpose of a transaction and the extent to which it alters the shareholders' relationship with the corporation. Later cases have cited this ruling when considering the tax implications of corporate reorganizations and stock transactions, emphasizing that a prearranged plan to sell shares received as a dividend or in a reorganization can negate any intended tax benefits, especially if the intent is primarily tax avoidance and there is no bona fide business purpose.

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