20 T.C. 352 (1953)

When a corporation distributes treasury stock, acquired using undivided profits, to its shareholders without converting surplus into capital stock, the distribution is considered a taxable dividend to the extent of the stock's fair market value.

Summary

In 1947, shareholders Schmitt and Lehren received a pro rata distribution of 1,486 shares of Wolverine Supply & Manufacturing Company stock, which Wolverine had purchased using its undivided profits. The Commissioner of Internal Revenue determined this was a taxable dividend. The Tax Court agreed with the Commissioner, holding that because the distribution came from undivided profits and did not involve a conversion of surplus to capital, it constituted a taxable dividend to the extent of the fair market value of the shares received. The court emphasized the substance of the transaction over its form, noting the company's history and intent.

Facts

James Lehren and Joseph Schmitt were president and vice-president, respectively, of Wolverine Supply & Manufacturing Company. Wolverine purchased 1,486 shares of its own stock from Dora Elliott Green. Lehren and Schmitt had previously attempted to purchase these shares themselves. Wolverine paid for the shares using corporate earnings. Wolverine's board later resolved to distribute these treasury shares to its shareholders, Lehren and Schmitt, pro rata based on existing holdings. No cash dividends were paid during the period the stock was acquired.

Procedural History

The Commissioner of Internal Revenue determined that the distribution of stock to Schmitt and Lehren constituted a taxable dividend, increasing their gross income accordingly. Schmitt and Lehren challenged this determination in the Tax Court. The Tax Court consolidated the proceedings and upheld the Commissioner's determination.

Issue(s)

1. Whether the distribution of Wolverine's capital stock to the petitioners in 1947 is essentially equivalent to a taxable dividend.

Holding

1. Yes, because the distribution of treasury stock, acquired with undivided profits, without converting surplus into capital, constitutes a taxable dividend to the extent of the fair market value of the shares.

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Court’s Reasoning

The court reasoned that a true stock dividend involves a transfer of surplus to capital stock. Citing and , the court emphasized that a stock dividend is a conversion of surplus into capital stock, distributed in lieu of a cash dividend. In this case, Wolverine used corporate earnings to purchase its own shares, which were then distributed to shareholders without any corresponding capitalization of surplus. The court noted the resolution explicitly stated the stock “represents undivided profits invested in said security.” The court distinguished this case from cases where the form and substance of the transaction coincided with a bona fide stock dividend. The court also focused on the overall picture, finding the corporation purchased the shares not to retain or retire them, but to transfer them to the petitioners. The court found that to rule otherwise would “permit the tactics employed here to be used as a means of tax evasion where corporate shares are closely held.”

Practical Implications

This case illustrates that the IRS and courts will look to the substance of a transaction, not merely its form, to determine its tax consequences. A distribution of treasury stock is not automatically treated as a tax-free stock dividend. Attorneys advising corporations on stock distributions must consider whether the distribution truly represents a capitalization of surplus or is simply a disguised way of distributing profits to shareholders. This case also serves as a warning that attempts to manipulate corporate structure for tax avoidance, particularly in closely held corporations, will be closely scrutinized and may be recharacterized for tax purposes. Later cases will look to whether a true conversion of surplus into capital stock occurred. The absence of such a conversion strongly suggests a taxable dividend.

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