26 T.C. 1046 (1956)

A pro rata stock redemption by a closely held corporation is essentially equivalent to a dividend, taxable as ordinary income, if it does not result in a meaningful reduction of the shareholders' proportional interests and is made out of accumulated earnings and profits, absent a substantial business purpose for the redemption.

Summary

The case of *Kessner v. Commissioner* concerns whether payments received by shareholders from a corporation's redemption of their preferred stock should be treated as taxable dividends or capital gains. The U.S. Tax Court ruled in favor of the Commissioner, holding that the redemption was essentially equivalent to a dividend. The court emphasized that the redemptions were pro rata, the shareholders' proportional interests in the corporation were unchanged, the corporation had substantial accumulated earnings and profits, and there was no significant corporate business purpose for the redemption. The court focused on the net effect of the transaction, concluding it was a distribution of corporate earnings that should be taxed as a dividend.

Facts

The petitioners, Samuel H. and Tessie D. Kessner, and Joseph and Mary Rabinowitz, were shareholders in Kessner and Rabinowitz, Inc. The corporation was formed from a partnership owned by the petitioners and Philip Kessner. The corporation authorized common and preferred stock. The preferred stock was non-voting, with a 5% non-cumulative dividend and redeemable at a premium. The corporation flourished, generating substantial earnings and profits. The corporation redeemed the preferred stock pro rata in two stages. The petitioners reported the proceeds of the redemptions differently, as a dividend in one year and as capital gains in another. The Commissioner determined that the redemptions were essentially equivalent to dividends and assessed tax deficiencies.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes for 1950 and 1951, based on the position that the stock redemptions were essentially taxable dividends. The petitioners contested these deficiencies in the U.S. Tax Court. The Tax Court consolidated the cases and ruled in favor of the Commissioner.

Issue(s)

1. Whether payments received by the petitioners in redemption of their preferred stock constituted dividends taxable as ordinary income under Section 115(g) of the Internal Revenue Code of 1939.

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Holding

1. Yes, because the court found the stock redemptions were essentially equivalent to the distribution of taxable dividends under Section 115(g)(1) of the Internal Revenue Code of 1939.

Court’s Reasoning

The court based its decision on Section 115(g)(1) of the Internal Revenue Code of 1939, which deals with the redemption of stock. The court explained that a redemption is considered equivalent to a taxable dividend if the distribution and cancellation or redemption are

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