***McDonald v. Commissioner, 52 T. C. 82 (1969)***

A stock redemption is not essentially equivalent to a dividend if it results in a substantial change in the shareholder's interest in the corporation.

**Summary**

In McDonald v. Commissioner, the Tax Court ruled that the redemption of Arthur McDonald's preferred stock in E & M Enterprises was not equivalent to a dividend. McDonald, who owned nearly all of E & M's stock, agreed to a plan where E & M redeemed his preferred stock before Borden Co. acquired the company in exchange for Borden's stock. The court found that the redemption was a step in Borden's acquisition plan and resulted in a significant change in McDonald's interest, justifying its treatment as a sale rather than a dividend. However, the court upheld the disallowance of McDonald's deduction for legal fees due to lack of evidence.

**Facts**

Arthur McDonald owned all of the nonvoting preferred stock and nearly all of the common stock of E & M Enterprises, Inc. In 1961, Borden Co. expressed interest in acquiring E & M. After initial negotiations, Borden proposed a plan where E & M would redeem McDonald's preferred stock for its book value of $43,500 before Borden acquired all of E & M's stock in exchange for Borden's stock. E & M obtained a bank loan to fund the redemption. The plan was executed, with McDonald receiving cash for his preferred stock and Borden stock for his common stock. McDonald reported the redemption as a capital transaction and the stock exchange as tax-free.

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in McDonald's 1961 income tax return, treating the redemption of preferred stock as a dividend. McDonald petitioned the U. S. Tax Court, which heard the case and issued its decision on April 16, 1969.

**Issue(s)**

1. Whether the redemption of McDonald's preferred stock by E & M Enterprises was essentially equivalent to a dividend under Section 302(b)(1) of the Internal Revenue Code.
2. Whether McDonald was entitled to a deduction for legal fees paid in 1961.

**Holding**

1. No, because the redemption was part of a plan that resulted in a substantial change in McDonald's interest in E & M, making it not equivalent to a dividend.
2. No, because McDonald failed to provide evidence that any portion of the legal

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fees was deductible.

**Court’s Reasoning**

The court applied Section 302 of the Internal Revenue Code, which treats a redemption as a sale if it is not essentially equivalent to a dividend. The court emphasized the context of the redemption as part of Borden’s acquisition plan, which resulted in a significant change in McDonald’s interest in E & M. The court rejected the Commissioner’s argument that the tax-free nature of the Borden stock exchange indicated continuity of interest, focusing instead on the practical change in McDonald’s investment. The court relied on cases like Zenz v. Quinlivan and Northup v. United States, which established that a substantial change in a shareholder’s interest could indicate that a redemption is not a dividend. The court accepted McDonald’s testimony that he was indifferent to receiving all Borden stock or a combination of cash and stock, reinforcing that the redemption was not a scheme to withdraw corporate earnings at favorable tax rates. On the legal fees issue, the court found no evidence to support a deduction.

**Practical Implications**

This decision clarifies that stock redemptions occurring as part of larger corporate transactions can be treated as sales rather than dividends if they result in a substantial change in the shareholder’s interest. Practitioners should analyze the overall plan and its impact on the shareholder’s position when advising on the tax treatment of redemptions. The decision may encourage structuring corporate acquisitions to include redemption steps, potentially allowing shareholders to realize capital gains treatment. However, it also underscores the importance of maintaining clear records to support any claimed deductions, as the court strictly enforced the burden of proof on the taxpayer regarding legal fees. Subsequent cases have cited McDonald in analyzing redemption transactions under Section 302, affirming its role in shaping tax treatment of corporate reorganizations.

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