Erickson v. Commissioner, 56 T. C. 1112 (1971)

Payments received by a shareholder from a Subchapter S corporation in a stock redemption are taxable as capital gain if the redemption agreement clearly specifies the payment as part of the redemption price.

Summary

Gordon Erickson sold his 250 shares in Mid-States Construction Co. , a Subchapter S corporation, to the company for a redemption price adjusted by the final profits of a construction job. Erickson treated the gain as capital gain, while the company reported parts of the payment as dividend and joint venture distributions. The Tax Court held that the entire amount received by Erickson was for stock redemption and thus should be taxed as capital gain. This decision impacted the taxable income calculations for the corporation and its remaining shareholders.

Facts

Gordon Erickson owned 250 shares of Mid-States Construction Co. , a Nebraska-based Subchapter S corporation. In 1965, he agreed to sell his shares to the company for $146,479, with adjustments based on the final profits of a construction job at Kirksville, Missouri. The final profits exceeded initial estimates, resulting in an additional $9,000 payment to Erickson, bringing the total to $155,479. Erickson reported this as long-term capital gain, while Mid-States treated $13,040 as a dividend and $30,992 as a joint venture distribution on its tax return.

Procedural History

The IRS issued deficiency notices to Erickson and another shareholder, W. Wayne Skinner, treating the disputed amounts as ordinary income. Both cases were consolidated and heard by the U. S. Tax Court, which ultimately ruled in favor of Erickson, classifying the entire payment as capital gain from stock redemption.

Issue(s)

1. Whether the amounts of $13,040 and $30,992 received by Erickson from Mid-States Construction Co. were payments for the redemption of his stock or distributions of dividends and joint venture profits.

Holding

1. Yes, because the April 12, 1965, agreement between Erickson and Mid-States explicitly provided for the redemption of Erickson’s stock, and the amounts in question were integral parts of the total redemption price.

Court’s Reasoning

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The Tax Court focused on the clear language of the redemption agreement, which indicated the payments were solely for stock redemption. The court rejected the notion of a separate joint venture, as the agreement contained no such provisions. The court emphasized that the redemption price could include a percentage of profits, and the entire amount was considered part of the redemption, qualifying for capital gain treatment. The court also noted that the initial accounting entries by Mid-States treated the payments as part of the stock redemption, and only later were they reclassified. The court upheld the IRS's adjustments to the taxable income of Mid-States and its remaining shareholders under the Subchapter S rules, as the redemption did not reduce the corporation's taxable income.

Practical Implications

This decision clarifies that for Subchapter S corporations, payments designated as part of a stock redemption price, even if contingent on future profits, should be treated as capital gain to the shareholder, not as ordinary income. It underscores the importance of clear contractual language in redemption agreements to ensure proper tax treatment. Legal practitioners must draft such agreements carefully to avoid ambiguity and potential recharacterization by the IRS. Businesses should be aware that such redemptions do not reduce the corporation's taxable income under Subchapter S rules. Subsequent cases have cited Erickson for its clear delineation of redemption payments from other types of corporate distributions.

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