Crown v. Commissioner, 58 T. C. 825 (1972)

When a corporation redeems preferred stock, payments made to satisfy a prior legal obligation to pay dividends are taxable as ordinary income under IRC Section 301, not as capital gains.

Summary

In Crown v. Commissioner, the Tax Court ruled that when General Dynamics Corp. (GD) redeemed its preferred stock, the portion of the redemption proceeds representing unpaid dividends from a prior quarter was taxable as ordinary income under IRC Section 301. GD had paid a common stock dividend before setting aside funds for the preferred stock dividend, creating a legal obligation to pay the preferred dividend. The court held that this obligation, existing independently of the redemption, must be treated as a dividend payment for tax purposes, distinguishing it from the redemption payment itself, which could be taxed as a capital gain under Section 302.

Facts

In 1966, GD declared and paid a dividend on its common stock on March 10 without paying or setting aside funds for the first quarter dividend on its preferred stock. On March 14, GD adopted a plan to redeem its preferred stock, and the redemption price included an amount for the unpaid first quarter dividend. The petitioners, who held the preferred stock, reported the entire redemption proceeds as capital gains. The Commissioner argued that the portion of the proceeds representing the unpaid dividend should be taxed as ordinary income.

Procedural History

The Commissioner determined deficiencies in the petitioners' income taxes for 1966, asserting that part of the redemption proceeds should be taxed as dividends. The Tax Court consolidated the cases of multiple petitioners and held that the portion of the redemption proceeds representing the unpaid preferred stock dividend was taxable as ordinary income under IRC Section 301.

Issue(s)

1. Whether GD had a legal obligation to pay the first quarterly dividend on the preferred stock prior to its redemption.
2. Whether the portion of the redemption proceeds representing the unpaid dividend is taxable under IRC Section 301 as a dividend or under Section 302 as a capital gain.

Holding

1. Yes, because GD declared and paid a common stock dividend before setting aside

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funds for the preferred stock dividend, creating a legal obligation to pay the preferred dividend.
2. Yes, because the portion of the redemption proceeds paid to satisfy the legal obligation to pay the preferred dividend is taxable as a dividend under IRC Section 301.

Court's Reasoning

The court interpreted GD's certificate of incorporation to require that preferred stock dividends be either declared and paid or declared and set aside for payment before common stock dividends could be declared or paid. By paying the common stock dividend without addressing the preferred stock dividend, GD incurred a legal obligation to pay the preferred dividend. The court distinguished between the redemption payment and the payment of the legal obligation to pay dividends, citing cases where distributions in liquidation were treated differently from debt repayments. The court rejected the petitioners' argument that the entire redemption proceeds should be treated as capital gains, holding that the portion representing the unpaid preferred dividend was taxable as ordinary income under Section 301.

Practical Implications

This decision clarifies that when a corporation redeems preferred stock, any portion of the proceeds paid to satisfy a pre-existing legal obligation to pay dividends must be treated as a dividend for tax purposes. Corporations should carefully consider the timing of dividend declarations and payments to avoid creating unintended tax liabilities for shareholders. This ruling may influence how corporations structure their dividend policies and redemption plans, especially when dealing with preferred stock. Subsequent cases have followed this principle, emphasizing the importance of distinguishing between redemption proceeds and payments for prior obligations.

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