Superior Beverage Co. v. Commissioner, 58 T. C. 918 (1972)

Employee stock with transfer restrictions can be excluded from ownership calculations when determining if corporations form a controlled group.

Summary

In Superior Beverage Co. v. Commissioner, the Tax Court held that stock owned by minority shareholder-employees of three related corporations was "excluded stock" under IRC sec. 1563(c)(2)(B)(ii), due to bylaw provisions restricting its transfer. This exclusion meant A. E. Huckins, the majority shareholder, was deemed to own over 80% of each company, making them a brother-sister controlled group under IRC sec. 1563(a)(2). As a result, each corporation was only entitled to one-third of the $25,000 surtax exemption. The decision turned on whether the transfer restrictions were bona fide reciprocal, which they were not, as Huckins could unilaterally remove them under California law.

Facts

Three related California corporations, Superior Beverage Co. of Redding and Red Bluff, Inc. , Superior Beverage Co. of Chico, Inc. , and Superior Beverage Co. of Marysville, Inc. , were engaged in distributing alcoholic beverages. A. E. Huckins and his family held significant shares in these companies. The bylaws of each corporation included a right of first refusal clause that required any shareholder wishing to sell their stock to first offer it to the company, and then to other shareholders if the company declined. This clause was printed on each stock certificate. Minority shareholders, including company employees, held stock subject to these restrictions. The IRS determined that these corporations constituted a controlled group under IRC sec. 1563(a)(2), impacting their surtax exemptions.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies in the corporations' income tax returns for the years 1966, 1967, and 1968, claiming they were a controlled group entitled to a reduced surtax exemption. The corporations petitioned the Tax Court for a redetermination of these deficiencies. The Tax Court upheld the Commissioner's determination, leading to the decision that the corporations were a controlled group and subject to the apportionment of the surtax exemption.

Issue(s)

1. Whether the stock owned by minority shareholder-employees of the three corporations was "excluded stock" under IRC sec. 1563(c)(2)(B)(ii) due to the transfer restrictions in the bylaws.
2. Whether the transfer restrictions in the bylaws constituted a "bona fide reciprocal stock purchase arrangement" under IRC sec. 1563(c)(2)(B)(ii), thereby preventing the stock from being treated as "excluded stock".

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Holding

1. Yes, because the right of first refusal in the bylaws substantially restricted or limited the employees' right to dispose of their stock, making it "excluded stock" under IRC sec. 1563(c)(2)(B)(ii).
2. No, because A. E. Huckins, as the majority shareholder, had the power under California law to unilaterally remove the transfer restrictions, rendering the arrangement not bona fide reciprocal.

Court's Reasoning

The Tax Court applied IRC sec. 1563(c)(2)(B)(ii), which excludes stock from ownership calculations if it is owned by employees and subject to conditions that substantially restrict or limit their right to dispose of it. The court relied on the precedent set in Barton Naphtha Co. , 56 T. C. 107, finding that the right of first refusal in the bylaws met this criterion. The court rejected the argument that the restrictions were part of a bona fide reciprocal arrangement because Huckins, as the majority shareholder, could remove these restrictions at will under California law, as established in Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283. This power made the reciprocal nature of the restrictions illusory. The court also considered the legislative history and regulations supporting the view that a right of first refusal is a substantial restriction. The court's decision was influenced by the policy of preventing manipulation of corporate structures to avoid tax obligations.

Practical Implications

This decision impacts how corporations with similar bylaw restrictions should be analyzed for controlled group status under IRC sec. 1563. It underscores the importance of considering state corporate law when assessing the validity of stock transfer restrictions. Practitioners must be aware that majority shareholders may have the power to unilaterally amend bylaws, affecting the tax treatment of related corporations. This ruling has implications for business planning, as it may influence decisions about stock ownership and corporate governance structures to optimize tax benefits. Subsequent cases, such as Rev. Rul. 70-252, have cited this decision in similar contexts involving stock restrictions and controlled group determinations.

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