H. & G. Industries, Inc. v. Commissioner, 60 T. C. 163 (1973)

Premiums paid to redeem preferred stock are not deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue Code.

Summary

H. & G. Industries, Inc. sought to deduct a $40,000 premium paid to redeem preferred stock issued to a small business investment corporation. The Tax Court, in a decision by Judge Quealy, ruled that such premiums are not deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue Code. The court found that the payment was a capital transaction, not a release from an onerous contract, and therefore not deductible. This ruling clarified that premiums paid to shareholders for redemption of stock do not qualify as deductible expenses, impacting how companies structure and report financial transactions related to stock redemption.

Facts

H. & G. Industries, Inc. needed capital for expansion and issued 2,000 shares of 8% convertible participating preferred stock to First Small Business Investment Corp. of New Jersey (SBIC) in 1963. The stock included an 8% cumulative preferred dividend and an additional dividend up to $14,000. In 1967, to refinance on better terms, H. & G. Industries redeemed the stock for $240,000, a $40,000 premium over the issuance price. The company claimed this premium as an ordinary and necessary business expense on its 1968 tax return, but the Commissioner denied the deduction.

Procedural History

The Commissioner determined deficiencies in H. & G. Industries' income tax for the fiscal years ending August 31, 1968, and August 31, 1969. The company contested the deficiency for 1968, leading to the case being heard in the United States Tax Court. The Tax Court ruled in favor of the Commissioner, denying the deduction for the premium paid on the redemption of preferred stock.

Issue(s)

1. Whether the premium paid by H. & G. Industries, Inc. to retire its preferred stock is deductible as an ordinary and necessary business expense under section 162 of the Internal Revenue Code.

Holding

1. No, because the premium paid to redeem preferred stock is considered a capital transaction and not an ordinary and necessary business expense under section 162.

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Court’s Reasoning

The court applied the principle that premiums paid to redeem a corporation’s own stock are capital transactions and not deductible as business expenses. The court cited John Wanamaker Philadelphia v. Commissioner, which established that such premiums are liquidating distributions upon stock, not deductible expenses. The court rejected H. & G. Industries’ argument that the premium was paid to release from an onerous contract, stating that even if true, it does not convert the transaction into a deductible expense. The court emphasized the distinction between payments to third parties for release from contracts and payments to shareholders for redemption of stock, noting that the former may be deductible but the latter is not. The court concluded that the premium was part of a corporate distribution in redemption of its stock and thus not deductible under section 162.

Practical Implications

This decision impacts how companies handle the financial and tax implications of redeeming preferred stock. Companies must recognize that premiums paid to redeem their own stock are capital transactions and cannot be deducted as business expenses. This ruling guides legal and financial professionals in advising corporations on the structuring of stock redemption transactions and the proper reporting for tax purposes. It also influences corporate finance strategies, as companies must consider the non-deductible nature of redemption premiums when planning capital structure changes. Subsequent cases have followed this precedent, reinforcing the distinction between capital transactions and deductible expenses in corporate tax law.

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