Stephens v. Commissioner, 60 T. C. 1004 (1973)

A corporation's payment of a shareholder's personal obligation to purchase another shareholder's stock can be treated as a taxable dividend to the shareholder relieved of the obligation.

Summary

In Stephens v. Commissioner, the U. S. Tax Court addressed whether a corporation's redemption of a shareholder's stock, which relieved another shareholder of a personal obligation to purchase that stock, constituted a taxable dividend. The Stephenses, shareholders of Our Own Deliveries, Inc. , a subchapter S corporation, agreed to purchase Thornbury's stock through a bidding process. When the corporation paid for Thornbury's stock, it was held that this payment relieved the Stephenses of their personal obligation, resulting in a taxable dividend to them. The court determined that the corporation's earnings and profits were sufficient to cover this dividend, despite prior stock redemptions.

Facts

Our Own Deliveries, Inc. , a subchapter S corporation, had four shareholders: Thomas C. Stephens, Taylor A. Stephens, Joseph G. Thornbury, Jr. , and two others who decided to sell their shares. The shareholders agreed that if any shareholder wished to sell, the remaining shareholders could purchase the stock at book value. In 1967, a bidding process was established for the Stephenses and Thornbury to bid on each other's stock. The Stephenses won the bid for Thornbury's stock, paying a deposit with a personal check. Subsequently, the corporation redeemed Thornbury's stock, paying the full amount, which included the Stephenses' obligation.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Stephenses' federal income tax, asserting that the corporation's payment for Thornbury's stock resulted in a taxable dividend to the Stephenses. The Stephenses contested this in the U. S. Tax Court, which heard the case and issued a decision under Rule 50.

Issue(s)

1. Whether the payment by Our Own Deliveries, Inc. , for Thornbury's stock constituted a distribution of money or property to the Stephenses, resulting in a taxable dividend?
2. Whether the corporation's agreement to redeem the stock of two shareholders reduced its earnings and profits prior to the payment for Thornbury's stock?

Holding

1. Yes, because the payment by the corporation relieved the Stephenses of their

personal obligation to purchase Thornbury's stock, resulting in a taxable dividend to them.
2. No, because the corporation's agreement to redeem the stock of the two shareholders did not constitute a distribution of an obligation or other property under section 312(a) of the Internal Revenue Code, and thus did not reduce earnings and profits before the payment for Thornbury's stock.

Court's Reasoning

The court found that the Stephenses incurred a personal obligation to purchase Thornbury's stock through the bidding process, evidenced by the stock purchase and sale agreement and the bids themselves. The court cited case law such as Wall v. United States, which holds that when a corporation relieves a shareholder of a personal obligation to purchase another's stock, the payment is considered a dividend to the relieved shareholder. The court rejected the Stephenses' argument that they were acting as agents for the corporation, noting that there was no evidence of such agency. Regarding earnings and profits, the court determined that the corporation's agreement to redeem the stock of the other two shareholders did not constitute a distribution of an obligation or property under section 312(a), and thus did not reduce earnings and profits before the payment for Thornbury's stock. The court concluded that the corporation had sufficient earnings and profits to enable the payment of the dividend to the Stephenses.

Practical Implications

This decision clarifies that when a corporation pays for stock to relieve a shareholder of a personal obligation, the payment can be treated as a taxable dividend to the shareholder. Legal practitioners should carefully document shareholder agreements to avoid unintended tax consequences. Corporations considering stock redemptions must assess their earnings and profits to determine the tax impact on remaining shareholders. This case may influence how subchapter S corporations manage stock redemptions and shareholder obligations, as it demonstrates the importance of understanding the tax treatment of such transactions. Subsequent cases, such as Sullivan v. United States, have followed this precedent, reinforcing the principle that a corporation's payment of a shareholder's obligation can result in a taxable dividend.