Estate of Milton S. Lennard, Deceased, Pauline Lennard and Gerald L. Lennard, Executors, and Pauline Lennard, Individually, Petitioners v. Commissioner of Internal Revenue, Respondent, 61 T. C. 554 (1974)

A stock redemption qualifies for capital gains treatment under IRC Sec. 302(b)(3) if the shareholder completely terminates their interest in the corporation, including as an officer, director, or employee, and retains only a creditor interest.

Summary

Milton Lennard sold all his shares in Gerald Metals, Inc. , to the company and resigned as an officer and director. Post-redemption, he continued to provide accounting services as an independent contractor. The IRS argued this constituted a retained interest, disqualifying the redemption from capital gains treatment. The Tax Court ruled in favor of the estate, holding that Lennard's role as an independent contractor and creditor did not violate the complete termination requirement of IRC Sec. 302(b)(3). This decision clarifies that independent contractor services do not constitute a retained interest in the corporation for tax purposes.

Facts

Milton Lennard invested $100,000 in Gerald Metals, Inc. , receiving one-third of the common and preferred stock. His son Gerald managed the company. In 1965, Milton agreed to sell his shares back to the corporation for $275,000, resigning as an officer and director. He continued providing accounting services through his accounting firm, Lennard, Resnick & Co. , receiving $250 per month, later increased to $500. The redemption payment included a $150,000 promissory note, subordinated to other corporate debts. Gerald subsequently increased his ownership to two-thirds of the stock.

Procedural History

The IRS determined deficiencies in the Lennards' 1965 and 1966 federal income taxes, treating the redemption proceeds as dividends. The estate appealed to the U. S. Tax Court, which held a trial and issued its opinion on January 29, 1974, ruling in favor of the estate.

Issue(s)

1. Whether the redemption of Milton Lennard's stock in Gerald Metals, Inc. , constituted a complete termination of his interest in the corporation under IRC Sec. 302(b)(3) and 302(c)(2) when he continued to render accounting services to the corporation after the redemption.
2. Whether the redemption of the stock constituted a transaction which was essentially equivalent to a dividend under IRC Sec. 302(b)(1).

Holding

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1. Yes, because Milton Lennard’s interest was completely terminated upon redemption; his continued accounting services were rendered as an independent contractor, not an employee, and his creditor status from the promissory note did not constitute a prohibited interest.
2. This issue was not addressed due to the ruling on the first issue.

Court’s Reasoning

The court focused on the nature of Lennard’s post-redemption relationship with the corporation. It determined that his accounting services were provided as an independent contractor, not an employee, citing IRC Sec. 302(c)(2)(A)(i) and the legislative history indicating Congress’s intent to prevent only those retaining a financial stake or control from qualifying for capital gains treatment. The court distinguished this case from Rev. Rul. 70-104, noting Lennard’s services were limited and not indicative of control. The court also held that the promissory note created a creditor relationship, not a proprietary interest, despite its subordination, as it was not dependent on corporate earnings and was repaid promptly. The court concluded that Lennard’s interest in the corporation was completely terminated, qualifying the redemption for capital gains treatment under IRC Sec. 302(b)(3).

Practical Implications

This decision is significant for tax planning involving stock redemptions. It clarifies that shareholders can continue to provide services to a corporation as independent contractors post-redemption without disqualifying the transaction from capital gains treatment. This ruling provides guidance on structuring redemptions to avoid dividend treatment, particularly in family-owned businesses where shareholders may wish to retain some connection with the company. It also underscores the importance of ensuring that any retained interests are strictly creditor-based and not dependent on corporate earnings. Subsequent cases have cited Lennard in distinguishing between employee and independent contractor relationships for tax purposes.

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