Smith v. Commissioner, 66 T. C. 622 (1976)

A non-pro-rata surrender of stock to a corporation without consideration results in an ordinary loss to the shareholder based on their basis in the surrendered stock.

Summary

Smith and Schleppy, major shareholders in Communication & Studies, Inc. , transferred shares to the corporation to resolve a dispute with a creditor. The Tax Court ruled that this transfer was not a contribution to capital because it was non-pro-rata, and since no consideration was received, it did not constitute a sale or exchange. Instead, the court held that Smith and Schleppy sustained an ordinary loss equal to their basis in the surrendered shares, as the primary purpose was to improve the corporation's financial condition rather than protect their employment.

Facts

Smith and Schleppy were major shareholders and officers of Communication & Studies, Inc. (C&S), which sold home reference works. C&S faced a financial dispute with Shareholders Associates, Inc. (Associates) over convertible notes. To resolve this dispute and avoid potential bankruptcy, C&S agreed to lower the conversion rate of the notes, which required additional shares to be reserved for conversion. Smith and Schleppy transferred 22,857 and 34,285 shares, respectively, to C&S to meet this requirement. The transfer was non-pro-rata among shareholders, and no direct consideration was received by Smith and Schleppy other than the improvement of C&S's financial condition.

Procedural History

Smith and Schleppy initially reported the stock transfers as capital gains on their tax returns. Upon audit, the IRS disallowed the gains and denied deductions claimed for the stock's value as business expenses. The Tax Court reviewed the case and determined that the transfers were neither contributions to capital nor sales or exchanges, but rather resulted in ordinary losses.

Issue(s)

1. Whether the transfer of stock by Smith and Schleppy to C&S was a contribution to capital.
2. Whether the transfer of stock constituted a sale or exchange.
3. If neither a contribution to capital nor a sale or exchange, what was the tax consequence of the transfer to Smith and Schleppy?

Holding

1. No, because the transfer was non-pro-rata among shareholders and thus not a contribution to capital.

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2. No, because no consideration was received by Smith and Schleppy, so the transfer was not a sale or exchange.
3. Smith and Schleppy sustained an ordinary loss equal to their basis in the surrendered stock because the primary purpose was to improve the corporation's financial condition.

Court's Reasoning

The court applied the rule that a non-pro-rata surrender of stock to a corporation without consideration is not a contribution to capital but results in an ordinary loss. The court distinguished this case from situations where shareholders transfer stock pro-rata, which would be treated as a capital contribution. The court emphasized that the primary purpose of the transfer was to improve C&S's financial condition to avoid bankruptcy, not to protect Smith and Schleppy's employment or to directly benefit them. The court noted that any potential increase in the value of the remaining shares held by Smith and Schleppy was de minimis since the transferred shares were reserved for possible conversion by Associates. The court cited *Estate of William H. Foster* and distinguished it from *J. K. Downer*, where consideration was received for the stock transfer. The court concluded that since no sale or exchange occurred, the loss should be measured by the basis in the surrendered stock.

Practical Implications

This decision clarifies that when shareholders transfer stock to a corporation without consideration and in a non-pro-rata manner, they may claim an ordinary loss based on their basis in the stock. Legal practitioners should advise clients that such transfers are not considered contributions to capital and do not qualify as sales or exchanges for tax purposes. This ruling may affect how shareholders and corporations structure stock transactions during financial distress, as it provides a potential tax benefit for shareholders willing to surrender stock to improve the corporation's financial condition. Subsequent cases have followed this precedent, reinforcing the principle that non-pro-rata stock surrenders without consideration result in ordinary losses.

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