Jack O. Chertkof and Sophie Chertkof, Petitioners v. Commissioner of Internal Revenue, Respondent, 72 T. C. 1113 (1979)

A shareholder's acquisition of a prohibited interest within 10 years of a stock redemption can result in the redemption being taxed as an ordinary dividend rather than as a capital gain.

Summary

In Chertkof v. Commissioner, the U. S. Tax Court ruled that a distribution made by E & T Realty Co. to Jack Chertkof in redemption of his stock was taxable as an ordinary dividend. The case centered on whether Chertkof's management agreement with the company, executed six months after his stock redemption, constituted a prohibited interest under Section 302(c)(2)(A) of the Internal Revenue Code. The court determined that Chertkof's broad management powers over the company's property gave him significant control over its operations, leading to the conclusion that he had reacquired a prohibited interest. This ruling underscores the importance of ensuring complete termination of interest post-redemption to avoid ordinary income taxation.

Facts

Jack Chertkof and his father David owned E & T Realty Co. , which operated the Essex Shopping Center in Baltimore County, Maryland. Due to disagreements over management, Jack's stock was redeemed in 1966 in exchange for a one-third undivided interest in the company's real estate. Subsequently, Jack's corporation, J. O. Chertkof Co. , entered into a management agreement with E & T, giving it exclusive management powers over the shopping center. This agreement was executed six months after the stock redemption.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Jack and Sophie Chertkof's 1966 federal income tax, treating the redemption as an ordinary dividend. The Tax Court heard the case, focusing on the valuation of the distributed property and whether the management agreement constituted a prohibited interest under Section 302(c)(2)(A).

Issue(s)

1. Whether the fair market value of the corporate distribution to Jack Chertkof was $320,488. 61 as determined by the court.
2. Whether the redemption of Jack Chertkof's stock constituted a complete termination of his interest in E & T Realty Co. under Section 302(b)(3) and the 10-year rule of Section 302(c)(2)(A).

Holding

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1. Yes, because the court found the valuation by the Commissioner's expert to be credible and supported by evidence.
2. No, because Jack Chertkof acquired a prohibited interest in E & T Realty Co. through the management agreement executed within 10 years of the stock redemption.

Court's Reasoning

The court valued the distribution at $320,488. 61 based on the expert's use of the income approach, which was deemed most appropriate for the income-producing property. Regarding the second issue, the court found that the management agreement gave Jack Chertkof significant control over E & T's operations, including negotiating leases and managing finances. This control was deemed to be a prohibited interest under Section 302(c)(2)(A), as it went beyond a mere creditor's interest. The court distinguished this case from Estate of Lennard v. Commissioner, where the taxpayer's post-redemption role was limited to accounting services without control over corporate policy. The court emphasized that Chertkof's management role directly impacted the profitability of both his own interest and E & T's remaining property, thus constituting a financial stake in the corporation.

Practical Implications

This decision highlights the importance of ensuring a complete termination of interest after a stock redemption to qualify for capital gains treatment. Practitioners must carefully structure post-redemption arrangements to avoid creating prohibited interests, such as management agreements that grant significant control over the corporation's business. This ruling may impact how similar cases are analyzed, emphasizing the need to scrutinize any post-redemption agreements for potential control over corporate affairs. Businesses engaging in stock redemptions must be cautious not to inadvertently create taxable events by granting former shareholders control over the company's operations. Subsequent cases, such as Lewis v. Commissioner, have reinforced the principle that retained financial stakes or control over management can trigger ordinary income taxation.

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