Roebling v. Commissioner, 77 T.C. 30 (1981)

A stock redemption is not essentially equivalent to a dividend when it is part of a firm and fixed plan to reduce a shareholder's interest in a corporation, resulting in a meaningful reduction of their proportionate ownership and rights, and when capitalized dividend arrearages in a recapitalization can constitute section 306 stock, taxable as ordinary income upon redemption or sale unless proven that tax avoidance was not a principal purpose.

Summary

In *Roebling v. Commissioner*, the Tax Court addressed whether the redemption of preferred stock was essentially equivalent to a dividend and the tax treatment of capitalized dividend arrearages. Mary Roebling, chairman of Trenton Trust, received proceeds from the redemption of her preferred stock and treated them as capital gains. The IRS argued the redemptions were essentially equivalent to dividends, taxable as ordinary income, and alternatively, that a portion was section 306 stock. The Tax Court held that the redemptions were not essentially equivalent to a dividend due to a firm plan to redeem all preferred stock, resulting in a meaningful reduction of Roebling's corporate interest, thus qualifying for capital gains treatment. However, the portion of the stock representing capitalized dividend arrearages was deemed section 306 stock and taxable as ordinary income because Roebling failed to prove that the recapitalization plan lacked a principal purpose of tax avoidance.

Facts

Trenton Trust Co. underwent a recapitalization in 1958 to simplify its capital structure and improve its financial position. Prior to 1958, it had preferred stock A, preferred stock B, and common stock outstanding. Preferred stock B had accumulated dividend arrearages. The recapitalization plan included: retiring preferred stock A, splitting preferred stock B 2-for-1 and capitalizing dividend arrearages, and issuing new common stock. The amended certificate of incorporation provided for cumulative dividends on preferred stock B, priority in liquidation, voting rights, and a mandatory annual redemption of $112,000 of preferred stock B. Mary Roebling, a major shareholder and chairman of the board, had inherited a large portion of preferred stock B from her husband. From 1965-1969, Trenton Trust redeemed some of Roebling's preferred stock B pursuant to the plan.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Roebling's income tax for 1965-1969, arguing that the preferred stock redemptions were essentially equivalent to dividends and/or constituted section 306 stock. Roebling petitioned the Tax Court, contesting these determinations.

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Issue(s)

1. Whether the redemption of Trenton Trust's preferred stock B from Roebling was "not essentially equivalent to a dividend" under Section 302(b)(1) of the Internal Revenue Code.
2. Whether the portion of preferred stock B representing capitalized dividend arrearages constituted section 306 stock, and if so, whether its redemption or sale was exempt from ordinary income treatment under section 306(b)(4) because it was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

Holding

1. No, the redemptions were not essentially equivalent to a dividend because they were part of a firm and fixed plan to redeem all preferred stock, resulting in a meaningful reduction of Roebling's proportionate interest in Trenton Trust.
2. Yes, the portion of preferred stock B representing capitalized dividend arrearages was section 306 stock, and no, Roebling failed to prove that the recapitalization plan did not have a principal purpose of federal income tax avoidance; therefore, the proceeds attributable to the capitalized arrearages are taxable as ordinary income.

Court's Reasoning

Regarding dividend equivalence, the court applied the standard from *United States v. Davis*, requiring a "meaningful reduction of the shareholder's proportionate interest." The court found a "firm and fixed plan" to redeem all preferred stock, evidenced by the recapitalization plan, the sinking fund, and consistent annual redemptions. The court emphasized that while business purpose is irrelevant to dividend equivalence, the existence of a plan is relevant. The redemptions, viewed as steps in this plan, resulted in a meaningful reduction of Roebling's voting rights and her rights to share in earnings and assets upon liquidation. Although Roebling remained a significant shareholder, her percentage of voting stock decreased from a majority to a minority position over time due to the redemptions. The court distinguished this case from closely held family corporation cases, noting Trenton Trust's public nature and regulatory oversight. The court stated, "We conclude that the redemptions of petitioner's preferred stock during the years before us were 'not essentially equivalent to a dividend' within the meaning of section 302(1)(b), and the amounts received therefrom are taxable as capital gains."

On section 306 stock, the court found that the portion of preferred stock B representing capitalized dividend arrearages ($6 per share) was indeed section 306 stock. Roebling argued for the exception in section 306(b)(4), requiring proof that the plan did not have a principal purpose of tax avoidance. The court held Roebling failed to meet this "heavy burden of proof." While there was no evidence of tax avoidance as the principal purpose, neither was there evidence proving the absence

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of such a purpose. The court noted the objective tax benefit of converting ordinary income (dividend arrearages) into capital gain through recapitalization and subsequent redemption. Therefore, the portion of redemption proceeds attributable to capitalized arrearages was taxable as ordinary income.

Practical Implications

Roebling v. Commissioner provides guidance on applying the "not essentially equivalent to a dividend" test in the context of ongoing stock redemption plans, particularly for publicly held companies under regulatory oversight. It highlights that a series of redemptions, if part of a firm and fixed plan to reduce shareholder interest, can qualify for capital gains treatment under section 302(b)(1), even for a major shareholder. The case also serves as a reminder of the stringent requirements to avoid section 306 ordinary income treatment when dealing with recapitalizations involving dividend arrearages. Taxpayers must demonstrate convincingly that tax avoidance was not a principal purpose of the recapitalization plan to qualify for the exception under section 306(b)(4). This case underscores the importance of documenting the business purposes behind corporate restructuring and redemption plans, especially when section 306 stock is involved.

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