Johnston v. Commissioner, 77 T. C. 679 (1981)

Stock redemptions are treated as dividends if they are not part of a firm and fixed plan to meaningfully reduce the shareholder's proportionate interest in the corporation.

Summary

In Johnston v. Commissioner, the U. S. Tax Court ruled that a 1976 stock redemption from a closely held family corporation was taxable as a dividend rather than as a capital gain. Mary Johnston had entered into a stock agreement post-divorce that required annual redemptions of her shares. However, the court found that the redemption was not part of a firm and fixed plan to reduce her interest in the company, primarily because she did not enforce the corporation's obligation to redeem in several years. This case highlights the importance of demonstrating a clear, enforceable plan when seeking capital gain treatment for stock redemptions in family corporations.

Facts

Mary Johnston divorced her husband in 1973, receiving 1,695 shares of Buddy Schoellkopf Products, Inc. (BSP). They entered into a property settlement and a stock agreement that obligated BSP to redeem 40 of her shares annually starting in 1974. BSP redeemed 40 shares in 1976, 1977, and 1978 but failed to do so in 1974, 1975, and 1979. Johnston did not enforce the redemption obligation in those years. In 1976, she reported the proceeds from the redemption as a capital gain, but the IRS determined it should be taxed as a dividend.

Procedural History

The IRS issued a notice of deficiency to Johnston, determining that the 1976 redemption should be taxed as a dividend. Johnston petitioned the U. S. Tax Court to challenge this determination. The Tax Court heard the case and issued its opinion on September 24, 1981.

Issue(s)

1. Whether the 1976 redemption of Johnston's BSP shares was essentially equivalent to a dividend under I. R. C. § 302(b)(1).

Holding

1. Yes, because the redemption was not part of a firm and fixed plan to meaningfully reduce Johnston's proportionate interest in BSP.

Court's Reasoning

The court applied the test from United States v. Davis, which requires a meaningful reduction in the shareholder's proportionate interest for a redemption to be treated as a capital gain. The court found that Johnston's ownership decreased by only 0.24% in 1976, which alone was not meaningful. Furthermore, the court held that the redemption was not part of a firm and fixed plan because Johnston failed to enforce BSP's redemption obligation in 1974, 1975, and 1979. The court noted that in a closely held family corporation, the plan could be changed by the actions of one or two shareholders, as evidenced by Johnston's reliance on her son's judgment regarding BSP's financial condition. The court concluded that the redemption was essentially equivalent to a dividend under I. R. C. § 302(b)(1).

Practical Implications

This decision emphasizes the importance of a firm and fixed plan for stock redemptions to qualify for capital gain treatment, particularly in closely held family corporations. Attorneys advising clients on stock redemption agreements should ensure that such agreements are strictly adhered to and enforced to avoid dividend treatment. The case also underscores the need for shareholders to actively manage and enforce their rights under redemption agreements, rather than relying on family members with potential conflicts of interest. Subsequent cases have cited Johnston to distinguish between enforceable redemption plans and those subject to the whims of family dynamics.

