Seda v. Commissioner, 82 T. C. 484 (1984)

Continued employment after a stock redemption can prevent the transaction from qualifying for long-term capital gain treatment under IRC Section 302(b)(3).

Summary

LaVerne V. Seda and LaVerne E. Seda sold all their stock in B & B Supply Co. to the corporation in 1979, transferring ownership to their son. Despite resigning as officers and directors, Mr. Seda continued working for the company, receiving a monthly salary. The Tax Court held that this employment disqualified the redemption from being treated as a complete termination under IRC Section 302(b)(3), attributing their son's stock ownership to them through family attribution rules. Consequently, the redemption proceeds were taxed as dividends, not capital gains. The court also ruled that payments received by Mr. Seda post-redemption were taxable as salary, not as part of the stock redemption.

Facts

LaVerne V. Seda and LaVerne E. Seda owned all the stock of B & B Supply Co. , a garage door wholesaler. In 1979, due to declining health, they decided to sell their stock to the corporation for $299,000 and resign from their positions as officers and directors. Their son, James L. Seda, became the sole shareholder after the redemption. Mr. Seda continued working for the company as an employee, receiving a $1,000 monthly salary for nearly two years after the redemption. The company had never paid dividends and had significant retained earnings.

Procedural History

The Sedas reported the redemption proceeds as long-term capital gains on their tax returns. The IRS issued a notice of deficiency, treating the proceeds as dividend distributions. The Sedas petitioned the U. S. Tax Court, which upheld the IRS's position, ruling that the redemption did not qualify for capital gain treatment under IRC Section 302(b)(3) due to Mr. Seda's continued employment.

Issue(s)

1. Whether the redemption of all the Sedas' stock in B & B Supply Co. qualified as a complete termination under IRC Section 302(b)(3), allowing for long-term capital gain treatment.
2. Whether payments received by Mr. Seda after the redemption were compensation for services or partial payment for his redeemed stock.

Holding

1. No, because Mr. Seda's continued employment with the company after the redemption meant he retained a financial interest, making the redemption not a

complete termination under IRC Section 302(b)(3).
2. No, because the payments to Mr. Seda were taxable as salary, not as part of the stock redemption.

Court's Reasoning

The court applied the family attribution rules under IRC Section 318(a)(1), which attribute stock owned by a family member to the shareholder unless the requirements of IRC Section 302(c)(2)(A) are met. Mr. Seda's continued employment as an employee, receiving a salary, violated the requirement of IRC Section 302(c)(2)(A)(i) that the shareholder must have no interest in the corporation post-redemption, including as an employee. The court rejected the Sedas' argument that not all employment relationships are prohibited, emphasizing that Mr. Seda retained a financial stake in the company through his salary. The court also considered the legislative intent behind Section 302(c)(2) to prevent tax avoidance by ensuring a bona fide severance of interest. A concurring opinion by Judge Whitaker advocated for a per se rule against any employment post-redemption, arguing for clarity and certainty in the application of the law.

Practical Implications

This decision underscores the importance of completely severing ties with a corporation after a stock redemption to achieve capital gain treatment. Legal practitioners must advise clients to resign from all positions and avoid any employment or remuneration from the corporation post-redemption to prevent the application of family attribution rules. This case may influence future transactions involving family-owned businesses, where planning for tax-efficient exits is critical. Subsequent cases have continued to apply these principles, emphasizing the need for a clear break from the corporation to avoid dividend treatment of redemption proceeds.