Lynch v. Commissioner, 83 T. C. 597 (1984)

A complete redemption of stock qualifies for capital gains treatment if the shareholder does not retain a prohibited interest in the corporation and tax avoidance was not a principal purpose of the stock transfer.

Summary

William M. Lynch transferred stock to his son and then had the remaining shares in W. M. Lynch Co. redeemed. The key issue was whether this redemption qualified as a complete termination of his interest under IRC § 302(b)(3), thus allowing capital gains treatment. The Tax Court held that Lynch did not retain a prohibited interest post-redemption and that tax avoidance was not a principal purpose of the stock transfer to his son, allowing the redemption to be treated as a capital gain rather than a dividend.

Facts

William M. Lynch founded W. M. Lynch Co. in 1960, initially owning all 2,350 shares. In 1975, he transferred 50 shares to his son, Gilbert, and the corporation redeemed the remaining 2,300 shares for $789,820. Post-redemption, Lynch entered into a consulting agreement with the corporation for $500 monthly for five years, though payments were later reduced and the agreement terminated early. Lynch also continued to be covered by the corporation's medical plans.

Procedural History

The Commissioner determined deficiencies in Lynch's federal income tax for 1974 and 1975, asserting that the redemption should be treated as a dividend. Lynch petitioned the U. S. Tax Court, which ruled in his favor, holding that the redemption qualified as a complete termination of his interest under IRC § 302(b)(3). The decision was reversed by the Court of Appeals for the Ninth Circuit on October 8, 1986.

Issue(s)

1. Whether the redemption of all of Lynch's stock in W. M. Lynch Co. qualified as a complete termination of his interest under IRC § 302(b)(3), thereby entitling him to capital gains treatment?
2. Whether Lynch retained a prohibited interest in the corporation post-redemption under IRC § 302(c)(2)(A)(i)?
3. Whether the transfer of stock to Lynch's son had as one of its principal purposes the avoidance of federal income tax under IRC § 302(c)(2)(B)?

Holding

1. Yes, because the redemption met the requirements of IRC § 302(b)(3) as Lynch

did not retain a prohibited interest and tax avoidance was not a principal purpose of the stock transfer.
2. No, because Lynch did not retain a financial stake or control over the corporation post-redemption.
3. No, because the transfer of stock to Lynch's son was intended to transfer ownership of the corporation to him, not for tax avoidance.

Court's Reasoning

The Tax Court applied IRC § 302(b)(3) and (c)(2) to determine if the redemption qualified as a complete termination. They concluded that Lynch did not retain a prohibited interest under IRC § 302(c)(2)(A)(i) because he was not an employee post-redemption, did not retain a financial stake, and did not control the corporation. The court found that the consulting agreement and medical benefits did not constitute a significant interest in the corporation's success. Furthermore, the court held that the transfer of stock to Lynch's son did not have tax avoidance as a principal purpose under IRC § 302(c)(2)(B), as it was intended to transfer ownership to him. The court rejected the Commissioner's argument that the redemption price was inflated, as this was not raised at trial.

Practical Implications

This decision impacts how complete stock redemptions are analyzed for tax purposes. It clarifies that a shareholder can enter into a consulting agreement post-redemption without retaining a prohibited interest, provided the agreement does not give them a significant financial stake or control over the corporation. The ruling also emphasizes the importance of examining the principal purpose of stock transfers in related-party transactions. Practitioners should note that similar cases will need to demonstrate a lack of tax avoidance motives in any related stock transfers. The decision was later reversed on appeal, highlighting the importance of appellate review in tax cases and the potential for differing interpretations of IRC § 302 provisions.