Cerone v. Commissioner, 87 T. C. 1 (1986)

Family hostility does not nullify family attribution rules in determining stock redemption tax treatment.

Summary

In Cerone v. Commissioner, the Tax Court held that family hostility does not negate the family attribution rules under IRC Sec. 318 when determining the tax treatment of stock redemptions. Michael N. Cerone and his son, who owned equal shares in Stockade Cafe, Inc. , redeemed Cerone's stock due to ongoing disputes. Despite the redemption, Cerone continued to work for the corporation. The court ruled that the redemption payments were taxable as dividends, not capital gains, because Cerone constructively owned all shares via attribution and retained a prohibited interest as an employee, failing to meet the requirements of IRC Sec. 302(b)(1) and (b)(3).

Facts

Michael N. Cerone and his son, Michael L. Cerone, were equal shareholders in Stockade Cafe, Inc. Their relationship became increasingly hostile due to disagreements over business management and Cerone's gambling activities, which threatened the corporation's liquor license. To resolve the conflict, the corporation redeemed Cerone's shares in January 1975. Despite the redemption, Cerone continued to work as an employee for the corporation, managing the cash register until at least 1979.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Cerone's and Stockade Cafe, Inc. 's taxes, treating the redemption payments as dividends. Cerone and the corporation petitioned the U. S. Tax Court, arguing that the payments should be treated as capital gains due to the redemption. The Tax Court consolidated the cases and ruled against the petitioners, affirming the Commissioner's determinations.

Issue(s)

1. Whether family hostility nullifies the family attribution rules under IRC Sec. 318 in determining if a stock redemption is essentially equivalent to a dividend under IRC Sec. 302(b)(1)?
2. Whether the redemption of Cerone's stock qualifies as a complete redemption under IRC Sec. 302(b)(3), given his continued employment with the corporation?

Holding

1. No, because the attribution rules under IRC Sec. 318 are mandatory and family hostility does not affect their application. The redemption did not reduce Cerone's

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proportionate interest in the corporation since he was deemed to own 100% of the stock both before and after the redemption.
2. No, because Cerone's continued employment with the corporation constituted a prohibited interest under IRC Sec. 302(c)(2)(A)(i), preventing the attribution rules from being waived and disqualifying the redemption as a complete termination under IRC Sec. 302(b)(3).

Court's Reasoning

The court applied the attribution rules of IRC Sec. 318, which treat Cerone as owning his son's shares, making him a 100% shareholder both before and after the redemption. The court rejected Cerone's argument that family hostility should negate these rules, citing United States v. Davis and Metzger Trust v. Commissioner, which mandate the application of attribution rules irrespective of family relations. The court found that Cerone's continued employment gave him a financial stake in the corporation, preventing the application of the exception to attribution rules under IRC Sec. 302(c)(2). The redemption payments were treated as dividends under IRC Sec. 301 because they did not qualify for capital gain treatment under IRC Sec. 302.

Practical Implications

This decision clarifies that family hostility does not provide an exception to the attribution rules in stock redemptions, impacting how attorneys structure such transactions. Practitioners must ensure that shareholders completely terminate their interest in the corporation, including any employment, to avoid attribution and qualify for capital gain treatment. Businesses should be cautious about retaining former shareholders as employees after redemption to prevent tax implications. Subsequent cases have continued to apply this ruling, emphasizing the importance of a complete severance of all interests in the corporation for favorable tax treatment of stock redemptions.

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