Frontier Savings Association and Subsidiaries v. Commissioner of Internal Revenue, 87 T. C. 665 (1986)

Stock dividends are not taxable when shareholders lack an election to receive them in cash or other property.

Summary

Frontier Savings Association received stock dividends from the Federal Home Loan Bank of Chicago in 1978 and 1979. The issue was whether these dividends were taxable under IRC section 305(b)(1), which taxes stock dividends if shareholders have an election to receive them in cash or property. The Tax Court held that the dividends were not taxable because shareholders did not have such an election. The court reasoned that the bank retained discretionary authority over stock redemptions, and shareholders could not unilaterally require cash redemption. This case clarifies that stock dividends remain non-taxable when the corporation, not the shareholders, controls the redemption process.

Facts

Frontier Savings Association, a mutual savings and loan association, was a stockholder of the Federal Home Loan Bank of Chicago. In 1978 and 1979, the Chicago Bank paid dividends to its member banks, including Frontier Savings, in the form of stock. Some member banks requested redemption of their shares, which the Chicago Bank had discretion to grant or deny. Frontier Savings received 588 shares in 1978 and 514 shares in 1979, along with cash for fractional shares. The Chicago Bank's policy allowed for stock redemptions upon member request, but it retained the final decision-making authority.

Procedural History

The Commissioner of Internal Revenue issued statutory notices of deficiency to Frontier Savings for the tax years 1977-1979, asserting that the stock dividends were taxable. Frontier Savings contested this in the U. S. Tax Court. The court consolidated the cases and ultimately ruled in favor of Frontier Savings, holding that the stock dividends were not taxable.

Issue(s)

1. Whether the stock dividends received by Frontier Savings in 1978 and 1979 from the Federal Home Loan Bank of Chicago were taxable under IRC section 305(b)(1).

Holding

1. No, because the shareholders did not have an election to receive the dividends in cash or other property. The Chicago Bank retained discretionary authority over stock redemptions, and shareholders could not unilaterally require cash redemption.

Court’s Reasoning

The court applied IRC section 305(a), which generally exempts stock dividends from taxation, and section 305(b)(1), which taxes them if shareholders have an election to receive them in cash or property. The court emphasized that the Chicago Bank’s discretionary authority over stock redemptions, as provided by the Federal Home Loan Bank Act and the bank’s own policies, meant that shareholders lacked the requisite election. The court noted that the timing of dividend distributions and the subsequent determination of excess shares further supported the lack of an election. The court also distinguished this case from others where shareholders had a clear right to elect cash, citing the discretionary language in the Chicago Bank’s policies and the statutory framework. The court rejected the Commissioner’s argument that a consistent practice of redemptions constituted an election, finding that the bank’s discretion was not abdicated.

Practical Implications

This decision clarifies that stock dividends remain non-taxable when the issuing corporation retains control over redemption decisions. Practitioners should advise clients that the mere possibility of redemption does not constitute an election under section 305(b)(1) unless shareholders can unilaterally demand cash. This ruling may influence how corporations structure dividend policies to avoid triggering taxable events. It also reaffirms the importance of statutory and corporate policy language in determining tax consequences. Subsequent cases, such as *Rinker v. United States*, have cited this decision in similar contexts. Businesses should review their dividend and redemption policies in light of this case to ensure compliance with tax laws.

