Hurst v. Commissioner, 124 T. C. 16 (2005)

In Hurst v. Commissioner, the U. S. Tax Court upheld the tax treatment of Richard and Mary Ann Hurst's sale of their stock in Hurst Mechanical, Inc. (HMI) and R. H. , Inc. (RHI) as a termination redemption under Section 302(b)(3) of the Internal Revenue Code. The court rejected the Commissioner's late attempt to apply Section 304 to the RHI sale, emphasizing the importance of timely raising issues. The decision clarifies the boundaries of family attribution rules and the tax implications of health insurance benefits for shareholders in S corporations.

Parties

Richard E. and Mary Ann Hurst (Petitioners) v. Commissioner of Internal Revenue (Respondent)

Facts

Richard Hurst founded Hurst Mechanical, Inc. (HMI), an S corporation, which he and his wife Mary Ann owned entirely until 1997. They also owned R. H. , Inc. (RHI), a smaller HVAC company, equally. In 1997, as part of their retirement plan, they sold RHI to HMI and HMI redeemed 90% of Mr. Hurst's stock, with the remaining 10% sold to their son Todd Hurst and two other employees. The transactions included cross-default and cross-collateralization provisions across stock redemption, lease agreements, and Mrs. Hurst's continued employment at HMI. The Hursts reported these transactions as installment sales of long-term capital assets on their 1997 tax return, which the Commissioner challenged, recharacterizing the income as dividends and immediate capital gains.

Procedural History

The Commissioner issued a notice of deficiency for the Hursts' 1997 tax year, determining a deficiency of $538,114 and an accuracy-related penalty of $107,622. 80. The Hursts filed a petition with the United States Tax Court. At trial, the focus was primarily on the HMI stock redemption, with the Commissioner later attempting to apply Section 304 to the RHI sale in posttrial briefing. The court's review was de novo.

Issue(s)

Whether the redemption of Richard Hurst's HMI stock qualified as a termination redemption under Section 302(b)(3) of the Internal Revenue Code?

Whether the sale of the Hursts' RHI stock to HMI should be treated as a redemption under Section 304 of the Internal Revenue Code?

Whether the cost of Mrs. Hurst's health insurance provided by HMI was taxable to her under Section 1372 of the Internal Revenue Code?

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Rule(s) of Law

A redemption of stock qualifies as a termination redemption under Section 302(b)(3) if it results in a complete termination of the shareholder's interest in the corporation, except as a creditor. Section 302(c)(2) provides that family attribution rules do not apply if the shareholder elects to have no interest other than as a creditor for at least 10 years.

Section 304 treats certain stock purchases between related corporations as redemptions under Section 302, applicable when one or more persons are in control of each of two corporations and one acquires stock in the other from the person(s) in control.

Under Section 1372(a), an S corporation employee who is a 2-percent shareholder must include the value of employer-paid health insurance in their gross income, subject to a deduction under Section 162(l)(1)(B).

Holding

The court held that the redemption of Mr. Hurst's HMI stock qualified as a termination redemption under Section 302(b)(3), as he retained no interest other than as a creditor. The court did not rule on the Commissioner's Section 304 argument regarding the RHI stock sale due to the issue being raised as a new matter posttrial. The court held that the cost of Mrs. Hurst's health insurance was taxable to her as a 2-percent shareholder, subject to a 40% deduction under Section 162(l)(1)(B).

Reasoning

The court's analysis for the HMI stock redemption focused on whether Mr. Hurst retained an interest in HMI other than as a creditor. The court found that the cross-default and cross-collateralization provisions did not constitute a prohibited interest, as they were consistent with common commercial practice and aimed to protect the Hursts' creditor status. The court rejected the Commissioner's argument that these provisions indicated a retained interest in HMI's management or earnings.

Regarding the RHI stock sale, the court declined to apply Section 304 as the issue was not raised until posttrial briefing, constituting a new matter rather than a new argument. The court emphasized the procedural importance of timely raising issues and noted that the Hursts had no opportunity to present evidence relevant to a Section 304 analysis.

For Mrs. Hurst's health insurance, the court applied Section 1372, finding her a 2-percent shareholder by attribution through her husband and son's ownership of HMI stock, making the insurance premiums taxable to her, subject to a partial deduction.

Disposition

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The court affirmed the termination redemption treatment of Mr. Hurst's HMI stock sale and did not rule on the Section 304 issue regarding the RHI sale. The court upheld the taxability of Mrs. Hurst's health insurance but allowed a 40% deduction. The accuracy-related penalty was not sustained.

Significance/Impact

This case clarifies the application of Section 302(b)(3) termination redemption rules, particularly the distinction between creditor interests and prohibited interests in the context of family-owned businesses. It underscores the procedural requirement for timely raising issues, as the Commissioner's late introduction of Section 304 was deemed a new matter. The case also reinforces the tax treatment of health insurance benefits for 2-percent shareholders in S corporations, balancing the inclusion of such benefits in income with a partial deduction. The decision provides guidance on structuring stock sales and redemptions to achieve favorable tax treatment while maintaining creditor protection.

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