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Federal Income Tax: Reduction of Par Value of Stocks Is Not a Partial Liquidation of Corporation

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ever, he can be made a party to the suit by court process, if he is within the jurisdiction; or he can be made a co-plaintiff without his consent, if he is a non-resident.¹⁵ The exercise of either of these two controls would not cause payments under the assigned contracts to revert to the patentee or to be applied to his use. Thus, although the patentee has retained title to the patents, it appears that he has met the *control test*.

Another test often applied is the *benefit test*. This test, which is based on the theory that the dominant purpose of the revenue act is the taxation of income to those who earned or otherwise created the right to receive it or to enjoy the benefit of it when paid,¹⁶ would probably not be invoked in this type of case. Where inventions and patents are the result of the labor of the assignor and where there is an assignment without consideration, the assignment may often represent the equivalent of salary previously earned, which might be taxable to the assignor under the benefit doctrine.¹⁷ But, since royalty payments are usually contingent and uncertain until exploitation of the patent by the licensee and are hardly the equivalent of salary previously earned, liability should not be based on this theory.

If it is granted that the *benefit test* is not applicable, and since the assignor has met the *control test*, the result reached in this decision would be justified. The case indicates that, even though an assignor retain a property right, he may so completely divest himself of the income-producing property that he thereby escapes income tax liability.

WILLIAM H. CAREY.

FEDERAL INCOME TAX: REDUCTION OF PAR VALUE OF
STOCK IS NOT A PARTIAL LIQUIDATION OF
CORPORATION

Sheehan v. Dana, 163 F. 2d 316 (C. C. A. 8th 1947)

Taxpayer, stockholder in a corporation, received tax-free stock dividends. By means of these stock dividends the corporation capitalized its

¹⁵Independent Wireless Teleg. Co. v. Radio Corp. of America, 269 U. S. 459 (1926), *rehearing denied*, 270 U. S. 84 (1926).

¹⁶Helvering v. Horst, 311 U. S. 112 (1940).

¹⁷*Ibid.*

current earnings and profits to take care of its increased capital requirements. Later, in 1934, the corporation for legitimate business reasons reduced the par value of all the outstanding shares of stock from \$100 to \$70 per share, intending to continue in business on a less extensive scale. The corporation transferred the amount thus released from its capital stock account to its surplus account. In 1935 and 1936 the corporation distributed to its stockholders cash payments, partly from current earnings and profits and partly from the surplus account created by the reduction of its capital stock account. Taxpayer, in his returns, included the distributions to him as dividends. This suit was instituted by the taxpayer to recover a refund of taxes paid on the distributions attributable to surplus. Taxpayer claimed that as the payments to him from the surplus were a return of capital, they were not taxable as dividends. The district court allowed recovery of the refund.¹ On appeal, HELD, the taxpayer was not entitled to a refund. *First*, earnings and profits capitalized by issuance of tax-free stock dividends remain earnings and profits for federal tax purposes and when distributed, constitute distributions from earnings and profits and not from capital. *Second*, a mere reduction in the par value of the outstanding shares is not a complete cancellation or redemption of a part of the corporation's stock; consequently the payments do not qualify as distributions in partial liquidation and do not become subject to treatment as an exchange, but are treated as taxable dividends. Judgment reversed.

Earnings and profits capitalized by the issuance of stock dividends remain earnings and profits for federal tax purposes and when distributed are subject to treatment as such.² However, even though distributions are from earnings and profits they are not necessarily treated as taxable dividends. They may still be distributions in partial liquidation, considered as part or full payment in exchange for the stock and taxable only to the extent of the gain realized,³ unless the stock was cancelled at such time and in such manner as to make the distribution one essentially equivalent to a taxable dividend.⁴ Under the Code definition of distributions in partial liquidation,⁵ the regulations authorize three methods to effect a

¹Dana v. Sheehan, 66 F. Supp. 47 (E. D. Mo. 1946).

²Commissioner v. Estate of Bedford, 325 U. S. 283 (1945); see 1 MERTENS, LAW OF FEDERAL INCOME TAXATION 490 (1942) in which the author declares that the point is academic under INT. REV. CODE §115(h).

³INT. REV. CODE §115(c).

⁴INT. REV. CODE §115(g).

⁵INT. REV. CODE §115(i), “. . . ‘amounts distributed in partial liquidation’ means a

cancellation or redemption of a part of the corporation's stock, one of which is to call in all the old shares and to issue new shares to replace a portion thereof.⁶ Under all three methods it is required that at least one share be completely cancelled. There is no reference to a transaction by which the par value of all the shares is reduced.

The few decisions on the point have generally maintained that a mere reduction of par value is not a cancellation or redemption of a corporation's stock within the provisions of the Code.⁷ An early case held that such a transaction is not a partial liquidation but that even if it were, the resulting distribution was essentially equivalent to a taxable dividend, and thus taxable in either event as such.⁸ Subsequent holdings, however, have decided squarely against a partial liquidation in similar situations, finding (a) that no one share had been completely cancelled,⁹ (b) that the distribution was a scheme to pay cash dividends under the guise of a capital transaction in partial liquidation,¹⁰ or (c) that there was no intent to curtail operations¹¹ or dissolve the business.¹² The court in the present case avoids a discussion of the last two reasons, neither of which should properly be considered—the Code does not require an intent to curtail or dissolve the business as a requisite for partial liquidation,¹³ and a tax avoidance motive would seem immaterial in the determination of a partial liquidation. Both of these considerations are probably important only in deciding whether, after a partial liquidation, the distributions are taxable as dividends.¹⁴ The holding of the court is placed

distribution by a corporation in complete cancellation or redemption of a part of its stock, . . .”

⁶26 CODE FED. REGS. §29.115-5 (Cum. Supp. 1944).

⁷*Beretta v. Commissioner*, 141 F.2d 452 (C. C. A. 5th 1944); *Wilcox v. Commissioner*, 137 F.2d 136 (C. C. A. 9th 1943); *Long v. Commissioner*, 5 T. C. 327 (1945), *aff'd* 155 F.2d 847 (C. C. A. 6th 1946). *Contra*: *Straub v. Commissioner*, 29 B. T. A. 216 (1933), *aff'd* 76 F.2d 388 (C. C. A. 3d 1935); *see* *Patty v. Helvering* 98 F.2d 717 (C. C. A. 2d 1938) (where the Commissioner apparently conceded the point).

⁸*Wilcox v. Commissioner*, 137 F.2d 136 (C. C. A. 9th, 1943).

⁹*Beretta v. Commissioner*, 141 F.2d 452 (C. C. A. 5th 1944).

¹⁰*Beretta v. Commissioner*, 141 F.2d 452 (C. C. A. 5th 1944); *Wilcox v. Commissioner*, 137 F.2d 136 (C. C. A. 9th 1943); *Long v. Commissioner*; 5 T. C. 327 (1945), *aff'd* 155 F.2d 847 (C. C. A. 6th 1946).

¹¹*Wilcox v. Commissioner*, 137 F.2d 136 (C. C. A. 9th 1943).

¹²*Beretta v. Commissioner*, 141 F.2d 452 (C. C. A. 5th 1944).

¹³INT. REV. CODE §115(i); Note, 47 YALE L. J. 1146, 1151 (1938).

¹⁴INT. REV. CODE §115(g); 1 MERTENS, *op. cit. supra* note 2, §9.123; Notes, 49 HARV.

squarely on the failure of the corporation to cancel or redeem a single share completely, the only defensible basis, in view of the definition, on which it could be held that there had not been a partial liquidation.

It is unfortunate, however, that the court did not discuss fully the elements of the problem that this case presented. The results reached by reducing the par value of stock may appear identical in substance with the results reached under the method allowed by the regulation,¹⁵ which contemplates calling in the old shares and issuing new shares for a portion thereof.¹⁶ A distinction between the two methods may seem to be merely formal and technical.¹⁷ To the corporation the only difference between the two procedures is that the latter causes a reduction in the number of shares outstanding. Each stockholder retains the same equity in the corporation, regardless of which method is used. Nevertheless, there is an important distinction between the two methods which should absolve the court from any charge of taking a strict and formal approach. For the purpose of determining gain or loss on partial liquidation, distributions are applied against only those shares which are cancelled.¹⁸ If a reduction of par value should be treated as a partial liquidation, the distributions would have to be applied against the entire number of shares held by the stockholder. Any gain recognized under this method would always be less than the gain recognized upon a cancellation of a part of the shares. Furthermore, the Code contemplates that a distribution in partial liquidation may result in a capital loss,¹⁹ but a distribution after a reduction in par value could never result in a capital loss to the stockholder, because there would have been no final disposition of the stock. The distribution in such a case would only reduce the basis of *all* the shares. Under the authorized method, however, since the distribution is treated as an exchange for the stock which is *retired*, a loss may result.²⁰ Thus, the principal case serves to emphasize the pitfalls which the unwary may en-

L. REV. 1344, 1346 (1938), 47 YALE L. J. 1146, 1157 (1938).

¹⁵Darrell, *Corporate Liquidations and the Federal Income Tax*, 89 U. OF PA. L. REV. 907, 911 (1941); Note, 55 HARV. L. REV. 835, 841 (1942).

¹⁶26 CODE FED. REGS. §29.115-5 (Cum. Supp. 1944).

¹⁷See note 15 *supra*.

¹⁸Malone v. Commissioner, 128 F.2d 967 (C. C. A. 5th 1942); Kelly v. Commissioner, 97 F.2d 915 (C. C. A. 2d 1938); Williams v. Commissioner, 28 B. T. A. 1279 (1933).

¹⁹INT. REV. CODE §115(c).

²⁰Cases cited note 18 *supra*.