# Zenz v. Quinlivan

213 F.2d 914 (6th Cir. 1954)

**Opinion**

Appellant is the widow of the person who was the motivating spirit behind the closed corporation which engaged in the business of excavating and laying of sewers. Through death of her husband she became the owner of all shares of stock issued by the corporation. She operated the business until remarriage, when her second husband assumed the management. As a result of a marital rift, separation, and final divorce, taxpayer sought to dispose of her company to a competitor who was anxious to eliminate competition.

Prospective buyer did not want to assume the tax liabilities which it was believed were inherent in the accumulated earnings and profits of the corporation. To avoid said profits and earnings as a source of future taxable dividends, buyer purchased part of taxpayer's stock for cash. Three weeks later, after corporate reorganization and corporate action, the corporation  redeemed the balance of taxpayer's stock, purchasing the same as treasury stock which absorbed substantially all of the accumulated earnings and surplus of the corporation.

[T]he general principle is well settled that a taxpayer has the legal right to decrease the amount of what otherwise would be his taxes or altogether avoid them, by means which the law permits. The taxpayer's motive to avoid taxation will not establish liability if the transaction  does not do so without it.

The question accordingly presented is not whether the overall transaction, admittedly carried out for the purpose of avoiding taxes, actually avoided taxes which would have been incurred if the transaction had taken a different form, but whether the sale constituted a taxable dividend or  the sale of a capital asset.

The basic precept underlying the capital gains theory of taxation as distinguished from ordinary income tax is the concept that a person who has developed an enterprise in which earnings have been accumulated over a period of years should not be required to expend the ordinary income tax rate in the one year when he withdraws from his enterprise and realizes his gain.

Common logic dictates that a fair basis of measuring income is not determined upon the profits on hand in the year of liquidation but is properly attributable to each year in which the profits were gained.

We cannot concur with the legal proposition enunciated by the District Court that a corporate distribution can be essentially equivalent to a taxable dividend even though that distribution extinguishes the shareholder's interest in the corporation. To the contrary, we are satisfied that where the taxpayer effects a redemption which completely extinguishes the taxpayer's interest in  the corporation, and does not retain any beneficial interest whatever, that such transaction is not the equivalent of the distribution of a taxable dividend as to him

The statutory concept of dividend is a distribution out of earnings and profits, and normally it is proportionate to shares and leaves the shareholder holding his shares as his capital investment.

Complete and partial liquidations are treated for the purpose of the statute, as sales with a consequent measure of gain or loss, even though the proceeds may to some extent be derived from earnings

The use of corporate earnings or profits to purchase and make payment for all the shares of a taxpayer's holdings in a corporation is not controlling, and the question as to whether the distribution in connection with the cancellation or the redemption of said stock is essentially equivalent to the distribution of a taxable dividend under the Internal Revenue Code and Treasury Regulation must depend upon the circumstances of each case.

Since the  intent of the taxpayer was to bring about a complete liquidation of her holdings and to become separated from all interest in the corporation, the conclusion is inevitable that the distribution of the earnings and profits by the corporation in payment for said stock was not made at such time and in such manner as to make the distribution and cancellation or redemption thereof essentially equivalent to the distribution of a taxable dividend.

We do not feel that a taxpayer should be penalized for exercising legal means to secure a tax advantage. The conduct  of this taxpayer does not appear to contravene the purport or congressional intent of the provisions of the Internal Revenue Act which taxpayer invoked.

We conclude that under the facts and circumstances of the present case the District Court was in error, and the taxpayer is not liable as a distributee of a taxable dividend under Section 115(g) of the Internal Revenue Code.