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COMMENTS

TAX WARNING

BEWARE OF PREFERRED STOCK IN CLOSED CORPORATIONS

Incorporators of closely held corporations frequently cause preferred stock to be issued to themselves with the idea that this will enable them to withdraw capital from the corporation in the future by a redemption of the preferred stock without paying income taxes on the amount of capital so withdrawn. This is a very dangerous practice taxwise and might result in the payment of unnecessary income taxes.

If a corporation issues preferred stock at one hundred dollars per share and the corporation has the right to redeem or call said preferred stock at one hundred and ten dollars per share, and if the corporation earns money and out of its earnings actually redeems a share of preferred stock belonging to Mr. A for one hundred and ten dollars, the entire sum of one hundred and ten dollars will probably be treated as a taxable dividend received by Mr. A. This is true because of the provisions of Section 115(g) of the Internal Revenue Code, which section reads as follows:

"Redemption of Stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

For decisions construing said section, see MEYER v. COMMISSIONER\(^1\), and BERETTA v. COMMISSIONER\(^2\). It is therefore recommended that in the formation of closed corporations preferred stock not be used but that, instead of preferred stock, the corporation should issue promissory notes or bonds. When the promissory notes or bonds are paid, the holders of the notes or bonds will be required to pay an income tax on the interest received but in the ordinary case not upon the principal amount of the indebtedness repaid.

However, a second warning should be given at this point: Do not use an amount of promissory notes or bonds which is excessively large in proportion to the amount of the capital stock. For example, it would not be advisable to form a corporation with five hundred dollars worth of capital stock and ninety-nine thousand five hundred dollars in prom-

\(^1\) 154 Fed. 2d 55 (C.C.A. 3d, 1946).
\(^2\) 141 Fed. 2d 452 (C.C.A. 5th, 1944).
issory notes or bonds. If this should be done the amounts of the promissory notes or bonds might be treated as amounts invested in the capital stock of the corporation.

Therefore, in closely held corporations, we should not ordinarily use preferred stock, and we should not use an excessive amount of promissory notes or bonds.


JUDICIAL REVIEW OF ADMINISTRATIVE ACTION IN FLORIDA—QUO WARRANTO

Among the extraordinary common law writs by which the courts have been enabled to review action of the administrative branch of the government is the writ of quo warranto. In many jurisdictions, this writ is the complement of mandamus, being used to prevent administrative action which is arbitrary or in excess of power; in others the writ is narrow in scope, being used only to test title to office or right to franchise. Florida appears to be of the latter class. Since prohibition lies only to prevent judicial or quasi-judicial action, recourse must be had to equity where it is necessary to prevent arbitrary ministerial action in excess of powers unless title to office can be challenged.

In previous issues, it has been pointed out that administrative law has been developed in the procedure by which courts review, correct, or prevent action of the executive branch of government.

Quo warranto is an ancient common law writ. Statutory elaborations and modifications since the reign of Edward I have altered the remedy, yet the basic purpose has remained the same. Blackstone defines quo warranto as "a high prerogative writ in the nature of a writ of right for the king against him who obtained or usurped any office, franchise, or liberty of the Crown, which also lay in case of non-user or long neglect of a franchise, or mis-user or abuse of it." The writ later became an information in the nature of quo warranto which was criminal in nature designed not only to oust the usurper, but to punish him by fine for such usurpation. The sands of time have since shifted and effectively obliterated this viewpoint, and an early Florida opinion is found which sets forth the modern concept. "The proceeding by information in the nature of quo warranto is essentially a civil proceeding, and the pleadings in it are as much subject to amendment as they are in ordinary civil actions. It is criminal only in form." 1

1 Blackstone 3 Com. 262, 4th Am. Ed. 322.

2 State v. Gleason, 12 Fla. 190 (1869).