Revenue Ruling 56-431

Dividend Waiver Deemed Ineffectual with Related Shareholders

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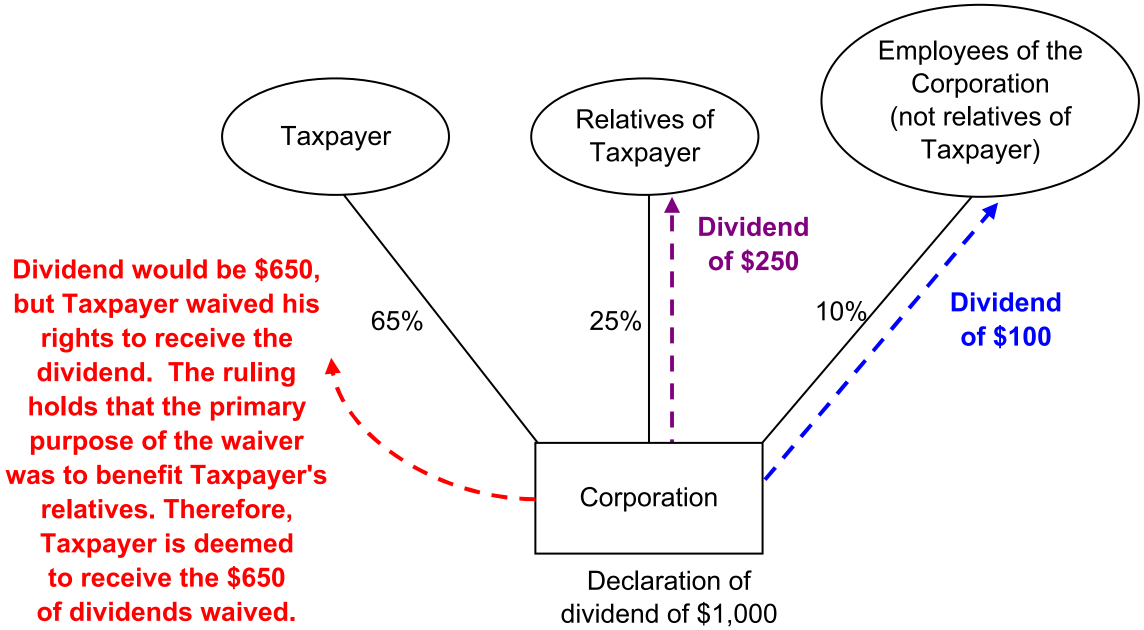

The taxpayer owns 65% of the capital stock of a corporation. Relatives of the taxpayer, including his minor children, own 25% of the stock. The remaining 10% of the stock is owned by employees of the corporation who are not relatives. Due to the necessity of keeping abreast of competition by procuring new equipment, the immediate and long-term working capital requirements of the corporation were such that payments of dividends in large amounts could not be made. No dividends had been paid by the corporation since its formation. However, the minority stockholders, most of whom are relatives of the majority stockholder, felt that they were entitled to a proper return on their investment. In order to meet this situation, the taxpayer waived his rights to any dividends declared by the corporation up to January 1, 1959. This permitted the distribution of dividends in substantial amounts to the minority stockholders without depleting the working capital of the corporation.

The ruling held that the benefits to be afforded the taxpayer's relatives by the waiver of his right to share in the dividend payments was the primary purpose for signing the waiver. The alleged business purpose to be served, namely, the payment of a larger dividend to minority stockholders who are key employees to maintain their good will, is merely incidental. Since the amounts distributed to the minority stockholders do not impair the capital by any greater amount than if distributed pro rata to all stockholders, the waiver is not considered necessary to protect the working capital of the corporation. Thus, the taxpayer's disposition of his power to receive his pro rata share of any dividends declared by the corporation, through effecting payment of such pro rata share to his relatives (including his minor children) as well as to his employees by the signing of a waiver must be considered the realization of income by him to the extent of dividend payments waived.