1 T.C. 611 (1943)

When a bona fide, unrestricted sale of stock occurs between a shareholder and a third party, followed by a separate transaction where the corporation repurchases the stock from the third party, the initial sale is taxed as a capital gain under Section 117, not as a corporate distribution in partial liquidation under Section 115 of the Revenue Act of 1934.

Summary

The Tully Trust case addresses the tax implications of a stock sale structured to avoid higher taxes. Shareholders of Corning Glass Works sold their stock to an independent third party (Chas. D. Barney & Co.), who then sold the stock back to Corning Glass Works. The Tax Court held that the initial sale to the third party was a bona fide transaction, subject to capital gains tax rates under Section 117 of the Revenue Act of 1934. The court rejected the IRS's argument that the transaction was a partial liquidation taxable at a higher rate under Section 115.

Facts

Several trusts and individuals (the Houghtons), who were second preference stockholders of Corning Glass Works, sought to sell 10,000 shares of their stock. Corning Glass Works authorized the purchase of these shares at $101 or less. The Houghtons, upon advice of counsel, decided to sell the stock to an outside third party to avoid potential tax liabilities associated with direct sale to the corporation. They arranged for the stock to be sold to Chas. D. Barney & Co. for $100.50 per share, with no restrictions. Barney & Co. then sold the same shares to Guaranty Trust Co. (acting for Corning Glass Works) for $101 per share.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes, arguing that the stock disposition should be treated as a distribution in partial liquidation of Corning Glass Works under Section 115(c) of the Revenue Act of 1934, making the gains fully taxable. The petitioners contested this determination, arguing that the transaction was a bona fide sale of a capital asset subject to the preferential tax rates under Section 117(a). The Tax Court consolidated the proceedings and ruled in favor of the petitioners.

Issue(s)

1. Whether the sale of Corning Glass Works stock by the petitioners to Chas. D. Barney & Co., followed by Barney & Co.'s sale to Guaranty Trust Co. (acting for Corning Glass Works), should be treated as a sale of a capital asset under Section 117(a) of the Revenue Act of 1934 or as a distribution in partial liquidation under Section 115(c) of the same act?

Holding

1. Yes, the sale should be treated as a sale of a capital asset under Section 117(a) because the initial sale to Chas. D. Barney & Co. was a bona fide, unrestricted transaction, independent from the subsequent repurchase by Corning Glass Works.

Court's Reasoning

The Tax Court reasoned that the sale to Chas. D. Barney & Co. was a separate and complete transaction. The court emphasized that Barney & Co. was under no obligation to resell the stock to Corning Glass Works, and the Houghtons had relinquished control of the shares. The court distinguished the transaction from a direct redemption, where Section 115(c) would apply. The court cited *Gregory v. Helvering, 293 U.S. 465 (1935)*, noting that a taxpayer has the legal right to minimize taxes by lawful means. The court found that the sale to Barney & Co. was indeed a lawful means; and, absent any restrictions on Barney & Co., the tax consequences should follow the form of the transaction. The court stated, "But when this is done and the evidentiary facts clearly show, as they do in the instant proceedings, that the sale is bona fide, that it was unrestricted, that the purchaser is bound by no commitments and is free to do with the property purchased whatever the purchaser desires, then the taxing authority must recognize the transaction for what it is."

Practical Implications

The Tully Trust case illustrates the importance of structuring transactions carefully to achieve desired tax outcomes. It confirms that a bona fide sale to a third party, even if motivated by tax considerations and followed by a repurchase by the original corporation, will generally be respected for tax purposes if the initial sale is unrestricted. This case is relevant for attorneys advising clients on stock sales and corporate redemptions. It shows that tax avoidance is permissible if executed through legitimate business transactions. It's often cited in cases involving step transactions and the economic substance doctrine. Subsequent cases have distinguished Tully Trust when the intermediate transaction lacks economic substance or when there are binding commitments linking the steps.

