1 T.C. 1131 (1943)

A bargain sale of corporate stock to shareholders for substantially less than its fair market value, with the knowledge and consent of other shareholders, can be treated as a distribution of corporate earnings and profits taxable as a dividend.

Summary

The Strake Trust case addresses whether the purchase of stock by the petitioners (trusts for the Strake children) from Strake Petroleum, Inc. at a price significantly below fair market value should be considered a taxable dividend. The Tax Court held that the difference between the fair market value and the purchase price was indeed a distribution of corporate earnings and profits taxable as a dividend. This decision was based on the fact that the sale was made with the knowledge and consent of all stockholders, indicating an intent to distribute corporate earnings.

Facts

Strake Petroleum, Inc. sold 300 shares of its treasury stock to each of the three Strake Trusts for $70,000 ($233.33 per share). The fair market value of the stock at the time of the sale was $268.85 per share. The sale was made with the knowledge and consent of all Strake Petroleum, Inc. stockholders. Strake Petroleum, Inc. had substantial earnings and profits exceeding $1,000,000 at the time of the sale. The trustee for each of the petitioners offered to purchase 300 shares of the 1,000 shares of Strake Petroleum, Inc. Treasury Stock.

Procedural History

The Commissioner of Internal Revenue determined that the difference between the purchase price and the fair market value constituted a distribution of earnings and profits taxable as a dividend. The Strake Trusts petitioned the Tax Court, arguing that the regulation used by the Commissioner was invalid. The Tax Court consolidated the cases and ruled in favor of the Commissioner.

Issue(s)

Whether the difference between the fair market value of stock and the price paid by shareholders in a bargain sale constitutes a distribution of earnings and profits taxable as a dividend when the sale is made with the knowledge and consent of the other shareholders.

Holding

Yes, because the sale of stock to shareholders for substantially less than its fair market value, with the knowledge and consent of other shareholders, effectively distributes corporate earnings and profits and is therefore taxable as a dividend.

Court's Reasoning

The Tax Court relied on Section 22 of the Revenue Act of 1928, which includes "dividends" in "gross income", and section 115, defining "dividend" as "any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits." The court cited Palmer v. Commissioner, stating that a sale of corporate assets to stockholders for substantially less than their value can be equivalent to a formal dividend declaration. The key factor is whether the transaction is "in purpose or effect used as an implement for the distribution of corporate earnings to stockholders." The court determined that because the sale was made with the knowledge and consent of all stockholders and Strake Petroleum had sufficient earnings and profits, the transaction was intended to distribute corporate earnings.

The court distinguished earlier cases that had invalidated similar regulations, noting that subsequent Supreme Court decisions had clarified that such bargain sales could be treated as dividends when they effectively distribute corporate earnings.

Practical Implications

The Strake Trust decision clarifies that the IRS and courts can look beyond the form of a transaction to its substance. A sale of stock or other assets to shareholders at a bargain price can be recharacterized as a dividend if the transaction effectively distributes corporate earnings, especially when done with the consent of all shareholders. This case informs how tax advisors must counsel clients on related-party transactions, emphasizing the need for arm's length pricing to avoid dividend treatment. Later cases applying this ruling emphasize examining the intent and effect of the transaction, considering factors such as the corporation's earnings and profits, the relationship between the parties, and whether the transaction was pro-rata among shareholders. This decision prevents corporations from disguising dividend distributions as sales to reduce shareholder tax liabilities.

