6 T.C. 1246 (1946)

A parent corporation cannot claim its subsidiary as part of an affiliated group for consolidated tax return purposes if the subsidiary's purported non-voting stock retains significant voting rights and dividend participation through separate agreements, effectively undermining the statutory requirements for affiliation.

Summary

Pioneer Parachute Co. sought to file a consolidated tax return with its parent company, Cheney Brothers. To meet the 95% voting stock ownership requirement, Pioneer created Class B preferred stock, exchanging it with minority shareholders for common stock. While the Class B stock was nominally non-voting, holders retained the right to convert to common stock before any shareholder meeting, effectively controlling voting. Furthermore, Pioneer guaranteed these shareholders a dividend equivalent to two-thirds of common stock dividends. The Tax Court held that this arrangement was a sham, Cheney Brothers did not meet the ownership requirements, and a consolidated return was not permissible.

Facts

Cheney Brothers owned 600 of Pioneer Parachute's 1,000 common stock shares. To qualify for consolidated tax returns, Cheney needed 95% ownership of Pioneer's voting stock. Pioneer created 398 shares of Class B preferred stock and offered it to minority shareholders (Smith and Ford) in exchange for their common stock. While designated as non-voting, the Class B preferred stock allowed holders to convert it to common stock before any shareholder meeting, effectively granting them voting power. Simultaneously, Pioneer agreed to pay Smith and Ford an amount equal to two-thirds of any dividends paid to common stockholders as long as they held the Class B preferred stock.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Pioneer Parachute Co.'s excess profits tax. Pioneer contested this determination, arguing it was entitled to file a consolidated return with Cheney Brothers. The Tax Court ruled in favor of the Commissioner, denying Pioneer's claim.

Issue(s)

1. Whether the Class B preferred stock issued by Pioneer Parachute Co. should be considered non-voting stock for the purpose of determining affiliated group status under Section 730 of the Internal Revenue Code.

2. Whether the Class B preferred stock was limited and preferred as to dividends, as required for exclusion from the definition of "stock" under Section 730 for consolidated return purposes.

Holding

1. No, because the Class B preferred stock retained the power to become voting stock at the holder's discretion prior to any shareholders meeting and thus was equivalent to voting stock.

2. No, because the side agreement guaranteeing holders of Class B preferred stock two-thirds of the dividends paid to common stockholders meant it was not truly limited as to dividends.

Court's Reasoning

The court reasoned that the Class B preferred stock's conversion privilege before shareholder meetings gave the holders substantial control over corporate governance. The court cited *Kansas, O. & G. Ry. Co. v. Helvering, 124 F.2d 460*, noting "*It is the voting privilege with which a particular stock issued is endowed and not whether it is voted which determines its voting character within the intent of the Revenue Acts of 1932 and 1934*." The court distinguished this case from situations where voting rights or dividend limitations were subject to contingencies outside the stockholders' control. Further, the side agreement guaranteeing dividend payments negated the "limited and preferred" nature of the stock, as these payments were directly linked to common stock dividends. The court concluded that the reorganization was a sham transaction designed solely to avoid taxes, referencing *Helvering v. Smith, 308 U.S. 473*: "*The government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute*."

Practical Implications

This case clarifies that the IRS and courts will look beyond the nominal characteristics of stock to determine its true nature for tax purposes. A corporation cannot artificially manipulate its capital structure to meet the technical requirements for consolidated tax returns if the underlying economic realities demonstrate a lack of genuine affiliation. Later cases have cited this ruling to emphasize the importance of substance over form in tax law and to scrutinize transactions lacking a legitimate business purpose beyond tax avoidance. It serves as a reminder that side agreements and retained rights can negate the intended tax consequences of a corporate reorganization.