8 T.C. 292 (1947)

A stock redemption by a corporation from its sole shareholder, where the payment equals the shareholder's cost basis and the corporation has sufficient earnings and profits, can be treated as a taxable dividend rather than a capital transaction.

Summary

Pullman, Inc., the sole stockholder of The Pullman Co., tendered 50,000 shares of Pullman Co. stock to the latter at Pullman, Inc.'s cost basis. The Tax Court determined that the transaction was essentially equivalent to a taxable dividend under Section 115(g) of the Internal Revenue Code. The court reasoned that because the payment was less than the subsidiary's accumulated earnings and profits and the proportionate interest of the stockholder was only negligibly affected, the distribution should be treated as a dividend. The court rejected Pullman, Inc.'s argument that the redemption was a partial liquidation dictated by the reasonable needs of the business.

Facts

Pullman, Inc. (petitioner), a holding company, owned over 99% of the capital stock of The Pullman Co. The Pullman Co. had accumulated earnings and profits of not less than $17,829,000 as of January 1, 1941. On September 17, 1941, Pullman, Inc. offered to sell 50,000 shares of Pullman Co. stock to The Pullman Co. at $100.85 per share, the value at which Pullman, Inc. carried the stock on its books. The Pullman Co. accepted the offer. The parties stipulated that the Pullman Co. intended to retire and cancel the shares. The Pullman Co. paid Pullman, Inc. $5,042,500 for the shares, which was Pullman, Inc.'s cost basis. The transaction reduced Pullman, Inc.'s ownership from 99.99444% to 99.99418%.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Pullman, Inc.'s income tax for 1941, contending that the stock redemption was essentially equivalent to a taxable dividend. Pullman, Inc. appealed to the United States Tax Court.

Issue(s)

Whether the distribution to petitioner by a subsidiary corporation in exchange for shares of the subsidiary's stock, which were then canceled, was essentially equivalent to a taxable dividend within the meaning of Section 115(g) of the Internal Revenue Code?

Holding

Yes, because the distribution was made out of accumulated earnings and profits, the

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proportionate interest and control of the petitioner was only negligibly reduced, and the transaction was given the fictitious form of a sale where the price did not reflect the fair market value of the shares.

Court's Reasoning

The court stated that a dividend typically results in the distribution of earnings and profits without significantly affecting the proportionate ownership of the corporation. The court found that this was the net effect of the distribution. The payment was made from accumulated earnings, and the proportionate interest was negligibly reduced. The court noted the price paid did not reflect the fair market value or the book value, but only the stockholder's tax basis. The court distinguished this case from cases where the distribution was dictated by the reasonable needs of the corporate business. Here, the Pullman Co. was conducting the same business, had no intention to liquidate, and had more cash than it needed. The court emphasized that "the net effect of the distribution, rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering section 115 (g)."

Practical Implications

This case illustrates that the IRS and courts will scrutinize stock redemptions, especially in closely held corporations, to determine if they are disguised dividends. Attorneys must advise clients that a stock redemption from a controlling shareholder can be treated as a taxable dividend if the distribution is made from earnings and profits and does not substantially alter the shareholder's control of the corporation. The price paid for the redeemed shares should reflect fair market value or book value rather than the shareholder's cost basis. The case emphasizes the importance of documenting a valid business purpose for the redemption, such as a genuine contraction of the business. Later cases have cited Pullman for the principle that the net effect of the transaction, rather than the taxpayer's intent, is the key factor in determining whether a stock redemption is equivalent to a dividend. This remains a crucial consideration in tax planning for corporate distributions.

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