Waterman Steamship Corporation v. Commissioner, 50 T. C. 650 (1968)

A dividend declared and paid before the legal and equitable ownership of stock passes to the buyer is treated as a dividend, not as part of the stock's purchase price, even if the transaction was structured to minimize tax liability.

Summary

Waterman Steamship Corporation rejected an initial $3. 5 million offer for its subsidiaries' stock but countered with a proposal to sell for $700,000 after a $2. 8 million dividend was declared. The dividend was paid via promissory note just before the stock sale. The Tax Court held that the dividend was genuine and not part of the purchase price, as it was declared and paid before the sale was finalized, allowing Waterman to eliminate the dividend from its taxable income due to consolidated filing. The case highlights the importance of timing and control in determining the substance of transactions for tax purposes.

Facts

Waterman Steamship Corporation owned all the stock of Pan-Atlantic Steamship Corp. and Gulf Florida Terminal Co. , Inc. Malcolm P. McLean offered to buy these subsidiaries' stock for $3. 5 million. Waterman rejected this offer but proposed to sell for $700,000 after Pan-Atlantic declared a $2. 8 million dividend to Waterman. On January 21, 1955, Pan-Atlantic declared the dividend via a promissory note, which was paid off an hour later with funds borrowed from the buyer, McLean Securities Corp. The stock sale was then completed for $700,000.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Waterman's income tax, treating the $2. 8 million as part of the stock's purchase price. Waterman filed a petition with the U. S. Tax Court, which heard the case and issued its decision on July 31, 1968.

Issue(s)

1. Whether the distribution of a promissory note by Pan-Atlantic to Waterman was a dividend or part of the purchase price for the sale of Pan-Atlantic and Gulf Florida stock?

Holding

1. No, because the dividend was declared and paid before the stock sale was finalized, and thus was not part of the purchase price but a genuine dividend to Waterman.

Court's Reasoning

The Tax Court focused on the substance of the transaction, emphasizing that Pan-Atlantic declared the dividend before any corporate action was taken to finalize the stock sale. The court rejected the Commissioner's argument that the transaction was a sham to avoid taxes, noting that Waterman retained legal and equitable ownership of the stock until after the dividend was declared. The court applied the principle that taxpayers can structure transactions to minimize taxes if there is substance to the transaction. The court distinguished this case from Steel Improvement & Forge Co. v. Commissioner, where the dividend was considered part of the purchase price because the beneficial ownership of the stock had passed to the buyer before the dividend was declared. The majority opinion concluded that the dividend was not a mere subterfuge, as it was a necessary part of the transaction to avoid ICC approval delays, and thus should be treated as a dividend. Judge Tannenwald dissented, arguing that no real dividend was paid because the note was temporary and the funds ultimately came from the buyer.

Practical Implications

This decision underscores the importance of timing and control in structuring corporate transactions for tax purposes. It reaffirms that a dividend paid before a stock sale is finalized can be treated as a dividend, not part of the purchase price, even if the transaction is structured to minimize taxes. This case provides guidance on how to structure stock sales and dividends to achieve tax benefits while ensuring the transaction has substance. Practitioners should carefully time corporate actions to ensure dividends are declared and paid before stock ownership changes hands. The case also highlights the potential for differing judicial interpretations of similar transactions, as seen in the dissent, emphasizing the need for clear documentation and adherence to legal formalities. Subsequent cases have applied this principle in determining the tax treatment of dividends in stock sale transactions.