Litton Industries, Inc. v. Commissioner, 89 T. C. 1086 (1987)

A dividend declared and paid by a subsidiary to its parent before the parent's efforts to sell the subsidiary is recognized as a dividend for tax purposes, not as part of the selling price.

Summary

Litton Industries declared a $30 million dividend from its wholly owned subsidiary, Stouffer Corp. , before announcing Stouffer's sale. The dividend was paid via a promissory note. Six months later, Litton sold Stouffer to Nestle for $75 million, with Nestle also purchasing the promissory note for $30 million. The Tax Court held that the $30 million was a dividend, not part of the sale proceeds, because the dividend was declared without a prearranged sale and Stouffer had sufficient earnings and profits. This decision emphasized the timing and independence of the dividend declaration from the sale, supporting its recognition as a dividend for tax purposes.

Facts

Litton Industries acquired Stouffer Corp. in 1967. In early 1972, Litton began discussing the sale of Stouffer. On August 23, 1972, before publicly announcing Stouffer's sale, Stouffer declared a $30 million dividend to Litton, paid by a negotiable promissory note. Litton announced the sale of Stouffer on September 7, 1972. Over the next six months, Litton explored various sale options, including public offerings. On March 1, 1973, Nestle offered to buy all of Stouffer's stock for $105 million. The sale was completed on March 5, 1973, for $74,962,518, with Nestle also paying $30 million for the promissory note.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Litton's federal corporate income tax for the year ended July 29, 1973, due to the treatment of the $30 million as part of the sale proceeds rather than a dividend. Litton contested this, arguing the amount was a dividend eligible for an 85% dividends-received deduction. The case was heard by the United States Tax Court, which issued its opinion on December 3, 1987.

Issue(s)

1. Whether the $30 million distribution from Stouffer to Litton, declared and paid by a promissory note before the sale of Stouffer, constitutes a dividend for tax purposes or part of the selling price of Stouffer's stock.

Holding

1. Yes, because the dividend was declared before any formal action to sell Stouffer, there was no prearranged sale, and Stouffer had sufficient earnings and profits at

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the time of the dividend declaration.

Court’s Reasoning

The Tax Court distinguished this case from Waterman Steamship Corp. v. Commissioner, where the dividend and sale were simultaneous and part of a single transaction. Here, the dividend was declared and paid before the sale was announced or arranged, and Stouffer had earnings and profits exceeding $30 million. The court noted that Litton had legitimate business purposes for the dividend, such as maximizing after-tax returns and not diminishing Stouffer’s stock value before a potential public offering. The court emphasized that the timing and independence of the dividend declaration from the sale supported its recognition as a dividend. The court also considered the absence of any sham or subterfuge in the transaction, as there was no prearranged sale agreement at the time of the dividend declaration.

Practical Implications

This decision underscores the importance of timing and independence in recognizing dividends for tax purposes. It allows corporations to declare dividends before initiating a sale without those dividends being recharacterized as part of the sale proceeds, provided there is no prearranged sale and sufficient earnings and profits. This ruling can influence corporate planning strategies, particularly in structuring transactions to maximize tax benefits. It also highlights the need for clear documentation and timing in corporate transactions to avoid disputes with tax authorities. Subsequent cases have cited Litton Industries in similar contexts, reinforcing its significance in tax law regarding dividends and sales.

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