Ralston Purina Co. v. Comm'r, 131 T. C. 29 (2008)

In Ralston Purina Co. v. Comm'r, the U. S. Tax Court ruled that payments made by a corporation to redeem its stock held by an employee stock ownership plan (ESOP), which were then distributed to departing employees, are not deductible under IRC Section 162(k). The court rejected the Ninth Circuit's contrary holding in Boise Cascade Corp. , emphasizing that such payments are inherently connected to stock redemptions, thus barred from deduction. This decision clarifies the scope of IRC Section 162(k), affecting how corporations manage ESOPs and tax planning strategies.

Parties

Ralston Purina Company and its subsidiaries were the petitioners at the trial level and throughout the proceedings before the United States Tax Court. The Commissioner of Internal Revenue was the respondent.

Facts

Ralston Purina Company, a Missouri corporation, established an Employee Stock Ownership Plan (ESOP) as part of its Savings Investment Plan (SIP) in 1989. The ESOP purchased 4,511,414 shares of newly issued convertible preferred stock from Ralston Purina at $110. 83 per share, financing the purchase through a $500 million loan guaranteed by Ralston Purina. The ESOP also purchased an additional 88,586 shares using employee contributions over the next three years. The preferred stock was entitled to receive semiannual dividends. Upon termination of employment, employees could elect to receive their ESOP investment in cash, prompting the ESOP to require Ralston Purina to redeem the preferred stock as needed to fund these distributions. In 1994 and 1995, Ralston Purina redeemed 28,224 and 56,645 shares of preferred stock, respectively, for a total of $9,406,031, which was distributed to departing employees. Ralston Purina sought to deduct these payments under IRC Section 404(k), arguing they were equivalent to dividends.

Procedural History

Ralston Purina timely filed its corporate income tax returns for the fiscal years ending September 30, 1994, and 1995, but did not initially claim deductions for the redemption payments. Following the Ninth Circuit's decision in Boise Cascade Corp. v. United States, Ralston Purina amended its petition to claim these deductions. The Commissioner contested the deductions, and both parties filed cross-motions for summary judgment. The Tax Court granted summary judgment in favor of the Commissioner, holding that the redemption payments were not deductible under IRC Section 162(k).

Issue(s)

Whether payments made by Ralston Purina to redeem its preferred stock held by its

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ESOP, which were subsequently distributed to departing employees, are deductible under IRC Section 404(k) despite the prohibition under IRC Section 162(k)?

Rule(s) of Law

IRC Section 162(k) disallows any deduction otherwise allowable for amounts paid or incurred by a corporation in connection with the redemption of its stock, with certain exceptions not applicable here. IRC Section 404(k) allows a deduction for dividends paid in cash by a corporation to an ESOP, provided those dividends are distributed to participants or used to repay ESOP loans.

Holding

The Tax Court held that the payments made by Ralston Purina to redeem its preferred stock and subsequently distributed to departing employees were not deductible under IRC Section 162(k). The court found that these payments were made in connection with a stock redemption and thus fell within the prohibition of Section 162(k), despite potentially qualifying as dividends under Section 404(k).

Reasoning

The court reasoned that the redemption payments were inherently connected to the stock redemption transaction. It rejected the Ninth Circuit's narrow interpretation of "in connection with" in Boise Cascade Corp. , which had allowed similar deductions. The Tax Court emphasized that the redemption and subsequent distribution to employees were part of an integrated transaction that qualified as an "applicable dividend" under Section 404(k). However, because the funds used for the redemption were the same funds distributed to employees, the entire transaction was barred from deduction under Section 162(k). The court noted that the legislative history of Section 162(k) indicated Congress's intent to disallow deductions for amounts used to repurchase stock. Furthermore, the court addressed the Commissioner's alternative argument under Section 404(k)(5)(A), which allows the Secretary to disallow deductions if they constitute tax evasion, but found it unnecessary to decide this issue given the holding under Section 162(k).

Disposition

The Tax Court granted the Commissioner's motion for summary judgment and denied Ralston Purina's motion for summary judgment, holding that the redemption payments were not deductible.

Significance/Impact

This decision clarified the application of IRC Section 162(k) to redemption payments made to ESOPs, directly impacting corporate tax planning involving stock redemptions and ESOPs. It established that such payments, even if structured as dividends, are not deductible if they are made in connection with a stock

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redemption. The ruling diverged from the Ninth Circuit's interpretation in Boise Cascade Corp. , creating a circuit split that may require further judicial or legislative clarification. The decision also highlighted the broad authority granted to the Commissioner under Section 404(k)(5)(A) to disallow deductions perceived as tax evasion, although this issue was not dispositive in the case. This case serves as a precedent for how courts may interpret the interplay between Sections 162(k) and 404(k) in future ESOP-related tax disputes.

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