COMMENT

TAXATION OF PRE-SALE, INTERCORPORATE DIVIDENDS: *WATERMAN STEAMSHIP CORP.*

The majority stockholder of a large eastern motor carrier sought to acquire ships and terminal facilities capable of transporting containerized freight between ports on the Gulf of Mexico and the eastern seaboard. Waterman Steamship Corporation (Waterman) operated such facilities through two wholly-owned subsidiaries, Pan-Atlantic, a water carrier, and Gulf Florida, a terminal and stevedoring business. Waterman had a basis of $700,000 in the stock of these subsidiaries, but because the profits had been retained and reinvested in the enterprises, the stock had a fair market value of $3,500,000. After rejecting the trucker's $3,500,000 cash offer to purchase the stock of the subsidiaries, Waterman counteroffered to sell the stock for $700,000 following a declaration and payment by the subsidiaries of a dividend of $2,800,000 accumulated earnings and profits. The motor carrier accepted this counteroffer, and Waterman caused Pan-Atlantic to declare and pay the dividend with a promissory note due one month after the declaration. Waterman then signed the agreement consummating the sale of its shares in the subsidiaries. Within two hours, the purchaser loaned $2,800,000 to Pan-Atlantic with which it paid the note representing the dividend.

On its consolidated income tax return Waterman excluded from taxable income the amount of the note, claiming it was an intercorporate dividend deductible under the current section 243 of the Internal Revenue Code.[1] The Commissioner asserted a deficiency, contending the note was a subterfuge and recasting the dividend as

[1] Section 243, as it then read, provided:

> In the case of a corporation . . . there shall be allowed as a deduction an amount equal to 85 percent of the amount received as dividends . . . from a domestic corporation . . . .

INT. REV. CODE OF 1954, § 243(a), *as amended,* INT. REV. CODE OF 1954, §§ 243 (a)(1)-(3).

The pertinent section now reads:

> In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:
>
> (1) 85 percent, in the case of dividends other than dividends described in paragraph (2) or (3);
>
> (2) 100 percent, in the case of dividends received by a small business investment company operating under the Small Business Investment Act of 1958; and
>
> (3) 100 percent, in the case of qualifying dividends (as defined in subsection (b)(1)).

A qualifying dividend is one paid by a corporation in the same affiliated group as the distributee. Corporations includible in an affiliated group are those related through stock ownership with a common parent corporation possessing at least 80% of the voting power of group subsidiaries. INT. REV. CODE OF 1954, §§ 243(b)(1), 1504(a).

part of the purchase price taxable as capital gain.[2] However, the Tax Court upheld the claimed deduction in *Waterman Steamship Corp.*,[3] ruling that a subsidiary's dividend distribution of accumulated earnings to its parent immediately before the parent sells its stock in the subsidiary qualifies as a deductible intercorporate dividend where no purchase agreement is consummated until after the dividend has been declared and paid.

The Tax Court majority framed the issue as whether, given the contemplated sale immediately following the subsidiary's distribution, the dividend form of the transaction should be respected for federal tax purposes.[4] The court acknowledged the taxpayer's right to reduce its taxable income by adopting that course which produced the smallest tax burden.[5] The opinion then stated that because substantially tax-free intercorporate dividends are authorized by the Code, and since the dividend was an integral part of the only transactional structure compatible with the purchaser's business objectives, the transaction should be treated according to the form in which it was cast: payment of an intercorporate dividend.[6]

Once a dividend was found, the ultimate result was determined by deciding to whom it was paid and taxable. Treasury Regulation 1.61-9(c) provides that dividends declared and paid before the sale of the underlying stock constitute income taxable to the seller.[7] Once an enforceable agreement has been consummated, however, the buyer becomes the beneficial owner of the stock and is entitled to, and taxable upon, receipt of any dividend paid.[8] The court distinguished "between a dividend declared and paid to the seller after execution of a written agreement for sale of stock and a dividend declared and paid prior to execution of a written agreement for sale of stock but after a general understanding as to the sale of the stock (not finally reduced to writing). . . ."[9] Admitting the distinction was "a shadowy one,"[10] the court emphasized that absent an enforceable sales agreement, the purchaser had no right to the stock and the seller remained the only party

---

[2] *See* INT. REV. CODE OF 1954, §§ 1201, 1221.

[3] 50 T.C. 650 (1968) (decision of Scott, J., reviewed by the court), *appeal pending*, Commissioner v. Waterman Steamship Corp., No. 27563 (5th Cir., filed March 28, 1969), *noted in* 22 VAND. L. REV. 228 (1968).

[4] 50 T.C. at 661.

[5] Where the transaction is carried out in a recognized form to accomplish its purpose and is not a sham or subterfuge, its substance should not be considered to differ from its form merely because the same result might have been accomplished by the parties by another method which would have produced a higher tax.

Id. at 665.

[6] *Id.* at 665-66.

[7] Treas. Reg. § 1.61-9(c).

[8] *See* Joseph L. O'Brien Co., 35 T.C. 750 (1961), *aff'd*, 301 F.2d 813 (3d Cir. 1962); Sam E. Wilson, Jr., 27 T.C. 976 (1957), *aff'd per curiam*, 255 F.2d 702 (5th Cir. 1958).

[9] *Id.* at 664.

[10] *Id.*

"who bears the operating risks of the business and stands to benefit from profits or suffer detriment from losses." [11] Since the *Waterman* transaction was of the latter variety,[12] the majority concluded that the note, and the cash received upon payment thereof, was properly deducted from the taxpayer's income under the intercorporate dividend provision.[13]

In dissent, three judges questioned whether a dividend had in fact been paid: "The plain and unadulterated fact is that no dividend was declared or paid by [the subsidiaries to the taxpayer]. The note issued was merely a piece of paper which served only a temporary purpose and disappeared." [14] However, although the majority and the dissent seem squarely at odds on the character of the $2,800,000 payment, the theory of the dissent is unclear. They may have contended that no valid indebtedness was created by the note; therefore, no dividend was paid. Or they may have reasoned that even if the note created a valid subsidiary-to-parent indebtedness, that finding does not foreclose the issue whether payment of that note must be characterized as a dividend or a portion of the purchase price.

---

[11] *Id.* This phrase, from Steel Improvement & Forge Co. v. Commissioner, 314 F.2d 96, 98 (6th Cir. 1963), *rev'g* 36 T.C. 265 (1961), was apparently thought to encapsulate the Sixth Circuit's formulation of the beneficial ownership test. In that case a United States corporation agreed to sell the outstanding stock of its Canadian subsidiary to a Canadian purchaser conditioned upon the declaration of a dividend. The subsidiary paid the dividend with funds supplied by the purchaser. Because the intercorporate dividend deduction applies only to dividends paid by "a domestic corporation which is subject to [United States] taxation," the U.S. parent argued the dividend form of the transaction should be disregarded and the amount received treated as part of the purchase price taxable as capital gain. *See* INT. REV. CODE OF 1954, § 243(a). The court apparently reasoned that because the conditioning event (payment of a dividend) was within the parent's control, the purchaser had an enforceable right to the stock and was, therefore, the beneficial owner of the stock at the time the dividend was declared and paid. *See* E. I. DuPont de Nemours Powder Co. v. Schlottman, 218 F. 353 (2d Cir.), *cert. denied,* 235 U.S. 705 (1914). The form of a dividend paid to the parent was recast as a dividend paid to the purchaser, with the immediate channeling of those funds back through the subsidiary as part of the purchase price taxable as capital gain. In *Steel Improvement,* both the Tax Court and Sixth Circuit recognized the validity of the dividend in the pre-sale context; the basis for reversal turned on the finding that the taxpayer was not the beneficial owner at the time the dividend was declared and paid.

[12] The [seller's counteroffer] was intended to result in [the parent-taxpayer] receiving in cash an amount it considered to be the approximate value of the [subsidiaries'] assets . . . without realizing taxable income . . . Since the transaction was planned to accomplish these purposes, the parties were careful that no firm contract for sale . . . was entered until after [the subsidiary] had declared a dividend and paid the dividend to [the parent-taxpayer] by delivery of its promissory note . . . .

50 T.C. at 661.

[13] Section 243(a)(1) authorizes a deduction of 85% of the amount received by a corporate taxpayer as dividends from a domestic corporation subject to federal income taxation. The section thereby reduces the effective maximum tax rate on dividends received by a corporation to 7.2% because the corporate tax rate of 48% is imposed on only 15% of the dividends received.

Because the taxpayer recognized no taxable income on payment of the note, judgment was entered pursuant to FED. R. CIV. P. 50, apparently to allow determination of the tax due on 15% of the amount received as a dividend.

[14] 50 T.C. at 666-67 (Tannenwald, Raum, Dawson & Simpson, JJ., dissenting).

A. *Validity of the Debt*

Although the Commissioner admitted that a dividend might properly be paid by a promissory note,[15] the facts that the subsidiary's liability was secured by the purchaser, that the principal amount of the note was subtracted from the purchase price of the stock and that the subsidiary two hours after the sale paid the note with funds obtained from the purchaser, convinced the dissenters that the note representing the dividend was "merely a piece of paper, which served only a temporary purpose and disappeared." [16] But the dissent cited no authority to support this conclusion.

In *Kraft Foods Co. v. Commissioner*,[17] the Commissioner contested the deductibility of interest payments, contending as in the instant case that the dividend distribution of a debt instrument did not create a valid corporate indebtedness. The Court of Appeals for the Second Circuit allowed the deduction, finding that neither the parent-subsidiary relationship, nor the transformation of an original equity interest into a debt interest, nor the alleged thin capitalization resulting from the transaction, nor the lack of any business purpose other than that of avoiding tax, was either singly or in combination sufficient to declare the debt invalid.[18] Other factors by which the validity of a purported debt are to be judged were developed in *Nassau Lens Co. v. Commissioner*.[19] They are an intention to repay, the extent to which the debt instrument bore a substantial risk of the enterprise, and the subordination of the instruments.[20] With these factors one could support a finding that the note was too ephemeral to be considered a valid debt, but in the face of the *Kraft* case this would be a rather strained holding. Moreover, it would serve only to avoid the more difficult and important issue in the case: the character of the payment made. Since the subsidiaries could have borrowed $2,800,000 from a third party and paid the dividend in cash, it does not necessarily follow that that payment should be characterized as a dividend for federal tax purposes.

B. *Dividend v. Purchase Price*

The *Waterman* transaction can be viewed in three alternative ways. First, a court could find that the form chosen by the taxpayer directly reflected the substance of the transaction: an intercorporate dividend followed by a sale of the parent's stock in the subsidiary.[21]

---

[15] 50 T.C. at 658 n.1.

[16] *Id.* at 667.

[17] 232 F.2d 118 (2d Cir. 1956).

[18] *Id.* at 123-28.

[19] 308 F.2d 39 (2d Cir. 1962).

[20] *Id.* at 47.

[21] Notes 1 & 3 *supra*.

Second, a court might agree with the Commissioner and the dissenters that there was no substance to the dividend: that the subsidiary was employed as a conduit for the payment of a portion of the purchase price of the stock.[22] Finally, it could be contended that because (but for the sale of stock necessitated by ICC regulation[23]) the taxpayer might substantially have reduced its taxable income through liquidation of the subsidiary, distribution of the assets to the parent, and subsequent sale by the parent to the purchaser, the taxpayer should not be taxed on a $2,800,000 capital gain.[24]

Comparison of these alternative structurings of the transaction illustrates the Code's inconsistent treatment of a corporation's disposition of its investment in a subsidiary. For some purposes the parent is treated as an investor in the stock of the subsidiary: when the parent disposes of its stock, gain is recognized in the amount of the difference between the parent's basis in the stock and the amount received from the sale. But for other purposes, the parent corporation is treated as the owner of the subsidiary's assets. For instance, a parent receiving property in a subsidiary's liquidating distribution will incur no tax liability and, with one major exception, will receive the basis that the property had in the hands of the subsidiary.[25] In *Waterman*, this inconsistency could permit widely disparate results: a sale of stock yields $2,800,000 of income taxable as a capital gain; but a liquidation of the subsidiary and sale of assets by the parent results in no taxable gain to this taxpayer.[26]

Noting that the Code treats a parent corporation as an investor in the stock of its subsidiary for certain purposes and an owner of its subsidiary's assets for other purposes provides no ready solution to the disputed tax consequences of a pre-sale extraction of a subsidiary's earnings and profits. The investor/owner dichotomy is more a symptom of the Code's differing treatment of transactions having

---

[22] Note 4 *supra.*

[23] The subsidiaries were certified water carriers. Apparently, purchase of all the subsidiaries' stock would have left the certified corporate entity unchanged such that the Interstate Commerce Commission would not have found it necessary to reassess the corporation's suitability for a certificate of public convenience. Obtaining ICC certification after the purchaser's direct acquisition of the assets might have required several years. For this reason the purchaser was unwilling to enter any transaction which required ICC approval. 50 T.C. at 652-53.

[24] No gain or loss is recognized on receipt by the parent corporation of property distributed by its subsidiary in a complete liquidation. INT. REV. CODE OF 1954, § 332. The subsidiary recognizes neither gain nor loss on distribution of its assets in liquidation. INT. REV. CODE OF 1954, § 336. Property received by the parent carries with it the adjusted basis that property had in the hands of the subsidiary. INT. REV. CODE OF 1954, § 334(b)(1). In *Waterman* the subsidiary's basis in its assets exceeded $3,500,000; therefore, the parent would have realized no gain upon their sale at that price and presumably would have incurred a recognizable loss. *See* 50 T.C. at 660.

[25] An analogous inconsistency adheres in the Code's treatment of sales of assets by the corporation, or by its shareholders after liquidation and distribution. *See* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 455-56 (1950).

[26] *See* note 24 *supra.*

identical economic consequences than a rationale for current taxation of parent-subsidiary transactions. It does, however, demonstrate that a parent corporation ordinarily has alternative ways of structuring the sale of its subsidiary which reduce the parent's taxable income. In *Waterman,* a fact extraneous to tax or economic considerations, the buyer's concern with anticipated ICC scrutiny of a sale of assets, restricted the taxpayer's alternatives. While the fact that a taxpayer could have structured a transaction another way is not a good argument for treating it as if he had done so, it does provide a reason for upholding a tax-minimizing form of the transaction if that form comports with the letter and policy of the provisions relied on.

Section 243 implements a congressional policy that corporations are not to be taxed on dividends received from affiliated corporations. This policy substantially prevents multiple taxation of corporate earnings as they pass from one corporation to another within the same chain of beneficial ownership.[27] However, deductibility under section 243 requires a "dividend" distribution; a pre-sale extraction of earnings and profits conflicts with the conception of a dividend as a distribution of earnings made in the context of an ongoing corporation-shareholder relationship.[28] In this light, a subsidiary's dividend declaration immediately before the complete disposition of the parent's interest in the stock of that subsidiary seems a hollow device lacking any business objective other than the extraction of earnings and profits without dividend consequences, especially when there is reason to believe no dividend would have been paid but for the contemplated sale.[29] Nevertheless, section 243 was specifically designed to prevent multiple taxation at the corporate level of earnings generated in a subsidiary and distributed to its parent. In *Waterman,* the income generated by the subsidiary never left corporate solution. It did become more readily accessible to the parent's stockholders through conversion of the parent's investment into cash, but a portion of the parent's investment is so converted whenever a subsidiary pays a cash dividend.

Conclusion

The method sanctioned by the Tax Court complies with both the letter and the congressional policy of section 243. Considering the Code's inconsistent treatment of a parent's disposition of its investment

---

[27] *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A62-63 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 222 (1954).

[28] This conception is perhaps more an intuitive one than an interpretation of § 316's definition of a dividend. A dividend as defined for income tax purposes includes any distribution by a corporation to its shareholders if it is made (1) out of accumulated earnings and profits, or (2) out of earnings and profits of the taxable year. Int. Rev. Code of 1954, § 316(a).

[29] According to the taxpayer, the parent corporation had considered an intercorporate dividend "for some time" prior to the sale. 60 T.C. at 653. But such an assertion is easily made and difficult to disprove. There was no other evidence to suggest the taxpayer would have caused a dividend declaration—especially of the size actually declared—had a sale not been planned.

in a subsidiary which normally allows a taxpayer a choice of tax results, Waterman should not have been assessed a deficiency based on a $2,800,000 capital gain.

Thus the Tax Court's decision allows the use of a pre-sale intercorporate dividend by a parent corporation planning the sale of a prosperous subsidiary, as a ready means (other than a sale of assets) by which to extract accumulated earnings and profits tax-free. Prearrangement of the dividend, sale, and financing of the dividend apparently will not jeopardize the desired tax benefit so long as the contract of sale is not executed until after the dividend is declared and paid to the seller.