United States Court of Appeals,
Sixth Circuit.
Jason L. HONIGMAN and Edith Honigman et al., Petitioners-Appellants, Petitioners-Cross-Appellees,
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee, Respondent-Cross-Appellant.
Nos. 71-1927, 71-1928.

Aug. 3, 1972.

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Before PHILLIPS, Chief Judge, and EDWARDS and CELEBREZZE, Circuit Judges.

PHILLIPS, Chief Judge.

This is an appeal and cross-appeal from a decision of the United States Tax Court reported at 55 T.C. 1067 (1971). We affirm as to the issues on appeal and reverse as to the issue on cross-appeal.

The principal controversy involves the tax consequences of the sale of corporate property below market value to a minority shareholder. A secondary unrelated question will be treated in Part III of this opinion, *infra*.

I.

Reference is made to the reported Tax Court decision for a detailed statement of the facts. The National Building Corporation was incorporated under the laws of Michigan in 1946 to engage in the ownership and operation of commercial real estate. Its principal stockholders were the Honigman family (35%), the Silberstein family (35%) and the Galperin family (20%). A member of each family held a position as a director and officer of National.

In early 1963 steps were undertaken to effect a complete liquidation of National. A preliminary agreement to sell its principal asset, the First National Building in Detroit, was entered into in February 1963. At that time, National's only unsuccessful investment was the Pantlind Hotel in downtown Grand Rapids, Michigan, which it had acquired in 1951. Taxpayers were aware that the Pantlind should be sold prior to adoption of the liquidation plan in order to permit the corporation to recognize the loss on this sale while shielding it from recognition of the substantial gains to be realized from the sale of the remaining assets. During this time, unsuccessful efforts were made to sell the hotel at offering prices ranging from $200,000 to $250,000 over its $590,000 mortgage. At an informal meeting of the directors in April, Jason Honigman proposed that the property be sold for a "nominal" price of $50,000 over mortgage. The hotel had not been offered preciously at this price, nor was such an offer ever made to outsiders. Ben Silberstein initially indicated an interest in the transaction, but subsequently declined the purchase. Honigman later decided to buy the property at the "nominal" price.

The Pantlind Hotel Corporation was organized under Michigan law to purchase the hotel for some $661,000, representing assumption of the mortgage and a $21,000 tax liability, and $50,000 cash. Mrs. Edith Honigman, wife of Jason Honigman, was the sole stockholder. Title was transferred on May 27, 1963. Two days later a further adjustment of about $38,000 was paid to National. At the time of the sale, National's adjusted basis in the Pantlind was approximately $1,486,000.

In August 1963 National adopted a qualified liquidation plan. All assets were sold within one year and the proceeds distributed pro rata to the shareholders.

The Honigmans reported no income from the May transaction on their 1963 joint income tax return. National deducted the difference between the sale price and the basis of the Pantlind as a business loss on its corporate tax return. The Commissioner determined a deficiency against the Honigmans individually, asserting that they had received a taxable dividend from the Pantlind sale equal to the excess of the fair market value over the purchase price. The fair market value was asserted by the Commissioner to have been $1,300,000. A further deficiency was asserted against the Honigmans as transferees of National, the Commissioner disallowing National's claimed loss deduction on the ground that the constructive dividend to the Honigmans was not recognizable as a loss by the corporation. Similar transferee liability was asserted against the Silbersteins and Galperins.

These deficiencies were contested in a consolidated Tax Court proceeding. The Tax Court found that the fair market value of the Pantlind at the time of sale was $830,000. The court held the transaction to have been a dividend to the Honigmans to the extent of the difference between the market value and sale price, and a sale to the extent of the difference between adjusted basis and market value. The former was held to be includible as income to the Honigmans and not deductible by National. The latter was held to be deductible by National.

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[The court of appeals sustained the Tax Court’s finding as to the fair market value of the Pantilind.]

The principal legal argument on behalf of the taxpayers is that the excess of fair market value over purchase price of an asset purchased from a corporation by a stockholder is a necessary but not sufficient condition for the declaration of a constructive dividend to the extent of the excess. It is urged that there also must be an intent to distribute a dividend and that such intent is negated by a showing that the sale was made in good faith for a valid business purpose to a noncontrolling stockholder.

We do not accept this argument. A dividend, includible in the recipient's gross income under § 301(c) [FN1] and not recognizable as a loss by the corporation under § 311(a), is defined in § 316 as follows:

FN1. All statutory references are to the Internal Revenue Code of 1954, as amended.

"§ 316. Dividend defined

"(a) General rule.-For purposes of this subtitle, the term 'dividend' means any distribution of property made by a corporation to its shareholders-

"(1) out of its earnings and profits accumulated after February 28, 1913, or

"(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection."

As stated by the Supreme Court:

"[I]t is clear that when a corporation sells corporate property to stockholders or their assignees at less than its fair market value, thus diminishing the net worth of the corporation, it is engaging in a 'distribution of property' as that term is used in § 316. Such a sale thus results in a dividend to shareholders unless some specific exception or qualification applies." Commissioner of Internal Revenue v. Gordon, 391 U.S. 83, 89-90, 88 S.Ct. 1517, 1521, 20 L.Ed.2d 448 (1968) (Footnote omitted.)

"If a distribution meets the requirements of the statutory definition of a dividend, then it is regarded as such notwithstanding the fact that it was intended to be a payment of some other kind. Christopher v. Burnet, 60 App.D.C. 365, 55 F.2d 527, 528 (1931); Hadley v. Commissioner of Internal Revenue, 59 App.D.C. 139, 36 F.2d 543, 544 (1929). It is not necessary that the dividend be formally declared, or that the payment be termed a dividend, or that the payment be made to all the shareholders. Lengsfield v. Commissioner of Internal Revenue, 241 F.2d 508, 511 (5th Cir. 1957); Regensburg v. Commissioner of

Internal Revenue, 144 F.2d 41, 44 (2d Cir.), cert. denied, 323 U.S. 783, 65 S.Ct. 272, 89 L.Ed. 625 (1944). For example, distributions have been regarded as dividends where a corporation makes a loan to a shareholder and later cancels the indebtedness, or sells property to a shareholder for a purchase price far below its fair market value, or pays compensation to an office-shareholder in an amount in excess of the value of his services. In cases such as these and others involving the same problem, courts have had little difficulty in holding the distribution or that part of it in excess of the *quid pro quo*, to be a dividend, notwithstanding the fact that neither the shareholder not the corporation 'intended' that a dividend be paid. It is not the intent of the parties that governs the characterization of the distribution, but rather the economic and consequent legal effect of their actions." Dynamics Corporation of America v. United States, 392 F.2d 241, 246-247, 183 Ct.Cl. 101 (1968). Accord United States v. Smith, 418 F.2d 589, 593-594 (5th Cir. 1969).

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The Tax Court found that the sale of the Pantlind below market diminished the net worth of National. There was no question that National had sufficient earnings and profits to support a dividend in the amount stated in the deficiency notice. Essentially the taxpayers urge this court to draw inferences from the evidence different from those drawn by the Tax Court. This we decline to do under the record in this case. Since we hold that there is no clear error in the findings of the Tax Court, we affirm....

Taxpayers further assert that the decision of the Tax Court was erroneous on the ground that the Pantlind was sold to a corporation not a shareholder of National. As noted by the Tax Court:

"Although in form, the sale was to Michigan Pantlind, a corporation, the parties both at trial and on brief have treated Edith Honigman, who owned 100 percent of Michigan Pantlind's stock at all times material to this case, as the purchaser of the hotel. In his notice of deficiency to the Honigmans, respondent explained his determination that a portion of the deficiency was 'the result of your *indirect purchase* of this property[the hotel] for less than its fair market value.' [Emphasis added.]" 55 T.C. at. 1077, n. 2.

Our examination of the record confirms that this was the posture of the case before the Tax Court. Further, the evidence shows to our satisfaction that, looking through form to substance, the sale was made to the Honigmans....

Accordingly, the decision of the Tax Court with respect to the individual liability of the Honigmans is affirmed.

II.

[We turn next to the cross appeal of the Commissioner. The Tax Court held that the sale of the Pantlind Hotel by National to the Honigmans was partly a constructive dividend and partly a sale. To reiterate the details of this transaction, the hotel had an adjusted basis to National of $1,468,168.51. The Honigmans purchased the hotel for $661,280.21. The Tax Court found that its fair market value was $830,000. It held that the transfer of the hotel to the Honigmans was to be treated for tax purposes as in part a dividend to the Honigmans in an amount equal to the difference between the purchase price and the hotel's fair market value (i. e., a constructive dividend of $168,719.79); and in part a sale to the extent of the excess of basis over fair market value. The Tax Court thus fragmented the transaction into part dividend, part sale. It further held that only the sale portion constituted a taxable event with respect to National. National was allowed a recognizable loss on this transaction to the extent of the difference between the fair market value of the hotel and its adjusted basis. Under the holding, National was allowed to allocate 100 per cent of the hotel's basis to the sale portion of the transaction.

The Commissioner asserts that this part of the decision of the Tax Court is in direct contravention of the Congressional purpose and nonrecognition mandate contained in § 311(a), which provides that no gain or loss shall be recognized to a corporation on distributions to a shareholder with respect to its stock.

The Commissioner contends that the purpose of § 311 is to segregate and remove from gain or loss recognition those distributions which are made to shareholders on account of their status as shareholders. We agree with the Commissioner.

The portion of the hotel transaction which the Tax Court held to be a constructive dividend distribution to the Honigmans represented a distribution to shareholders with respect to National's stock under § 301. The non-recognition of loss provision contained in § 311 would prohibit any recognition of loss on this part of the transaction. Yet, by allowing National a loss on the transaction measured by the difference between the hotel's adjusted basis and its fair market value, the Tax Court has permitted National to receive the benefit of a loss on that portion of the transaction held to be a distribution with respect to National's stock. We agree with the Commissioner that in order to give effect to the requirement of § 311, the basis of the hotel must be fragmented proportionately between the sales aspect and the distribution aspect of the transaction. The sale portion should be given recognition only to the extent that the basis allowable to the sale exceeds the consideration paid. Since the Honigmans paid $661,280 for the hotel property which had a fair market value of $830,000, they have purchased in their capacity as buyers a fractional interest represented by $661,280/$830,000. The loss resulting to National from the sale portion of the transaction thus should be computed by allocating a like per cent of the adjusted basis ($1,174,534) to the sale portion, which would result in a recognized loss to National of the difference between the consideration paid and the proportionate share of the basis allocated to the consideration paid.

In the present case, using approximate figures for the the purchase price ($660,000), market value ($830,000) and adjusted basis ($1,470,000), approximately 66/83 of the property was sold and 17/83 was distributed as a dividend.

Therefore, we reverse as to that part of the decision of the Tax Court covered by the cross-appeal of the Commissioner. We remand for recomputation of the loss properly recognizable by National and the resulting amount of transferee liability for each of the taxpayers.

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