**H.J. Heinz Co. v. United States**

**76 Fed. Cl. 570 (2007)**

ALLEGRA, J.

[In 1983, Heinz Co., a Pennsylvania food products manufacturer, organized HCC as a Delaware subsidiary to undertake financing activities previously carried out directly by Heinz. HCC’s principal activity was to borrow money from outside lenders and lend the same money to Heinz’s operating subsidiaries. The purpose for forming the new Delaware subsidiary was to minimize the state income tax liability on profits earned from the financing activities. Because HCC had no office or employees of its own (with Heinz management essentially making all of the decisions for its subsidiary), Pennsylvania state tax officials questioned Heinz as early as 1984 whether the separate existence of HCC should be respected, or whether the two companies should simply be treated as a single Pennsylvania entity for state tax purposes. Tax officials from other states also questioned whether in view of HCC’s structure, income tax should be paid to their states as a result of certain of its other financing activities. This controversy and uncertainty continued throughout the period of the transaction described below. During the years at issue, Heinz, HCC, and Heinz’s other subsidiaries all joined together to file a consolidated return for federal income tax purposes with Heinz, as the common parent of the group, responsible for the group’s tax liability.

In late 1994, HCC purchased on the open market 3.5 million shares of Heinz common stock for approximately $129 million plus $2 million in transaction costs. HCC borrowed much of the money needed for the purchase. In January 1995, HCC sold 3.325 million of the Heinz shares back to Heinz in exchange for a zero coupon note (the “Note”) that promised to pay the holder about $197 million in seven years’ time. In addition, beginning three years after issuance and continuing until maturity, the Note was convertible into 3.51 million shares of Heinz common stock. According to Goldman Sachs, Heinz’s investment banker, the Note, including its conversion privilege, was “reasonably valued” at $130.5 million when issued, or the same value as the shares bought back by Heinz. The purchase by HCC and share buyback by Heinz occurred during a period in which Heinz was regularly engaged in purchasing its own common stock on the open market for various corporate purposes.

In May 1995, HCC sold its remaining 175,000 Heinz shares to AT&T for about $7 million in cash. Thus, HCC’s short-term investment in Heinz stock produced about a $6.5 million profit ($130.5 million note plus $7 million cash less $131 million purchase price and transaction costs). In addition, during the period it held the Heinz stock, HCC received about $1.7 million in Heinz dividends and paid an unspecified amount of borrowing costs.

Because of the conversion privilege obtained by HCC when its Heinz shares were bought back by Heinz, the taxpayer took the position that the redemption should be treated as a dividend from Heinz to HCC which, under the consolidated income tax regulations, was not taxable to HCC. Dividend characterization followed from the fact that, as a result of attribution from holding the option, HCC’s interest in Heinz actually *increased* following the redemption. See I.R.C. §318(a)(4). The taxpayer therefore claimed that HCC’s basis in the shares sold back to Heinz shifted over to HCC’s remaining 175,000 shares in Heinz. Thus, the sale of those shares to AT&T resulted in a $124 million capital loss ($7 million amount realized less $131 million total basis). This loss was carried back to offset significant capital gains realized by the group in 1992-94.]

…If plaintiff is correct, transactions that, for financial accounting purposes, produced more than a $6 million profit, yielded, for tax purposes, a loss of over $124 million. Understanding how this might be the case requires a review of how the Code treats some intercorporate transactions.

…The parties agree that the 3,325,000 shares that Heinz obtained from HCC had a basis in HCC’s hands of $124.2 million. Heinz asserts that it “redeemed” these shares with the Note within the meaning of section 317(b) of the Code, which provides that “stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.” Defendant admits that *if* a true redemption occurred, it would be treated as a dividend under section 302(d) of the Code. It further admits that *if* a true redemption occurred, and a dividend arose under section 302(d), the transfer of stock from HCC to Heinz did not reduce the former’s equity position in the latter, so that the basis HCC had in the3,325,000 shares would shift to HCC’s remaining 175,000 shares. And defendant acknowledges that *if* this shifting in basis occurred, HCC was entitled to deduct a huge capital loss upon the subsequent sale of those 175,000 shares to AT&T.

In the tax law, “if” is a colossal word. Should the transaction in which Heinz acquired the 3,325,000 shares actually be considered a redemption within the meaning of section 317(b)? If it is not, plaintiffs essentially concede that HCC’s basis in the 3,325,000 shares did not shift to its remaining stock and that the subsequent sale of the latter stock did not produce a loss. In arguing for this result, defendant makes several points. First, it contends that no redemption occurred under section 317(b) because Heinz did not exchange property for the stock within the meaning of that section. Second, defendant asseverates that even if the transaction technically qualified as a “redemption” within the meaning of section 317(b), the transaction should not be treated as such because it lacked economic substance and had *no bona* fide business purpose other than to produce tax benefits; it was, in a word, a sham. Finally, it asserts that under the so-called “step transaction doctrine,” the purchase of the stock by HCC and the exchange of the stock for the Note should be merged together and viewed as a direct purchase of the stock by Heinz.…

Section 317(b) presupposes that the individual or corporation receiving property from the redeeming corporation, in fact, possesses the stock being redeemed. In arguing that this requirement was not met here, defendant asserts that HCC had a transitory interest in the Heinz shares that should not be respected for tax purposes because it did not have the benefits and burdens of that ownership.…

In the case *sub judice*, several factors suggest that HCC’s ownership of the Heinz stock was more than notional. HCC incurred significant indebtedness to generate the funds that were used to purchase the Heinz stock on the market, indebtedness that was not guaranteed by its parent. Further, unlike in other cases, HCC received dividends on the stock during the period of its possession.…And HCC, and not Heinz, bore the risk of loss and the opportunity for gain as to the value of the Heinz stock it possessed—indeed, from the time that it obtained the Heinz stock between August and November of 1994, to the time it sold it in January of 1995, the stock appreciated, a fact that was reflected in the purchase price in the parties’ agreement. Moreover, while the evidence on this point is a bit mixed, on balance, it appears that HCC was under no preexisting obligation to distribute or disgorge any profits it received—either in the form of dividends received, gain realized on the sale, or otherwise—to its parent.…Accordingly, and setting aside, briefly, other substance-over-form considerations, it appears preliminarily that HCC possessed the burdens and benefits associated with the Heinz stock and, to that extent, the later redemption qualified under section 317(b).…

Plaintiffs have the burden of proving that the portion of the transaction in question that saw HCC acquire shares and then transfer them to Heinz had both a business purpose and economic substance. As to the former, plaintiffs assert that HCC acquired the stock as an investment and to add “substance” to its operations for state tax law purposes. Both claims have decidedly hollow rings.

Plaintiffs’ assertion that HCC acquired the Heinz stock for investment purposes finds cosmetic support in the relevant corporate minutes, which mention this as a reason for approving the acquisition. However, any notion that this claim was authentic is belied, *inter alia*, by the testimony of Mr. Crowe, a Heinz vice president and its chief tax advisor, who admitted that, before HCC purchased any Heinz stock, Heinz planned on redeeming all but a small portion of that stock, with the residue stock being left with HCC only as part of a plan to produce the desired carryback losses. Indeed, as will be described in greater detail below, HCC had already hired Goldman Sachs to design the Note that would be exchanged for the Heinz stock at least six weeks before it acquired its first share. Moreover, the record suggests that HCC could not have reasonably viewed its temporary holding of the Heinz stock as a *bona fide* short-term investment. For one thing, the investment fundamentals of the transaction were all wrong—HCC acquired that stock on the open market at the then current price even though it knew that, unless the stock was registered, it would have to sell it in a private placement at a discount (which is what occurred). Moreover, HCC not only had to borrow funds and pay interest to effectuate this purchase, but incurred nearly $2 million in other expenses and fees in making the purchases, even though Heinz and HCC both knew that all but a small portion of the stock would be redeemed within a matter of months. Ironically, the most damning testimony on this point came from plaintiffs’ expert, Mr. Hatton. In explaining why he believed that it was not a foregone conclusion that HCC would exercise the stock conversion feature in the Note, Mr. Hatton emphasized how poorly Heinz’s stock had fared in the three years prior to the transaction, noting that Heinz had “drastically underperformed the market.” Mr. Hatton further testified that the actual increases that occurred in Heinz’s stock value in the three years following the issuance of the Note were “unforeseen,” adding that during this bull market period, Heinz “still underperformed versus the S&P 500.”

Lastly, HCC could not “invest” in the Heinz stock and also fully participate in the Heinz stock repurchase program. The main purpose of that program—to reacquire common shares to be held in the Heinz treasury to deal with stock options, preferred stock conversions and other corporate purposes—could not be accomplished so long as HCC held the Heinz stock in its treasury as an “investment,” a fact verified by several witnesses. Moreover, unlike the shares held in its treasury, Heinz was obligated to pay dividends on the shares held by HCC, undercutting the impact that the repurchase would have on its equity standing. Of course, this was not a problem as the record indicates that, *ab initio*, plaintiffs had every intention of making sure that the shares ended up with the parent. For this and the others reasons discussed above, the court rejects the notion that a non-tax business purpose was served here by having HCC “invest” in its parent’s stock.

Perhaps sensing this outcome, plaintiffs’ banner assertion at trial was that HCC purchased the Heinz stock to bolster its “substance” as a Delaware-based corporation, so as to lessen the likelihood that it would be disregarded by state taxing officials. There are at least four major flaws in this assertion.

First, nothing in the record suggests that anyone associated with Heinz thought, at the time, that HCC’s purchase of the Heinz stock would improve its stature as a Delaware holding company—there is no hint of this in the Heinz and HCC corporate minutes, the Heinz internal working papers, the series of memoranda prepared by Heinz tax officials detailing the steps that should be taken to bolster HCC’s status, and even the documents discussing the Heinz stock purchase itself. Nothing whatsoever. It is thus fair to conclude that this claim is of relatively recent vintage, a fact that undercuts its legitimacy. Second, the record reveals that Heinz officials knew or should have known that the stock purchase would not improve HCC’s status in prior taxable years. By the time the stock acquisitions began in 1994, HCC had been operating either out of a desk drawer or with a single employee for a number of years and the debate over its operations already was coming to a head, with various states—among them, Pennsylvania, Connecticut, New York and North Carolina—already having challenged its status as a separate company. Internal documents tellingly reveal that Heinz officials knew full well that there was nothing that they could do in 1994 or 1995 to limit their exposure for prior taxable years, with Mr. Crowe, Heinz’s primary tax manager, soberly stating that “[n]othing can be done about the lack of substance in prior years” and that “[w]e must simply hope that our luck holds.” Third, the record demonstrates that Heinz officials knew or should have known that the stock acquisition would not improve HCC’s status in fiscal year 1995 or thereafter. In fact, they knew that there very likely would not be such subsequent years because, according to testimony, Heinz was contemporaneously planning to have HCC cease its Delaware lending operations, such as they were.

Overall, it strains credibility to imagine that, with state officials around the country actively pursuing the misuse of Delaware holding companies and with HCC already the target of various audits, Heinz officials seriously believed that having HCC act as a conduit, in purchasing and reselling its parent stock within the same fiscal year, would be viewed by state taxing officials as adding much of anything to HCC’s “substance.” Plaintiffs have not explained how they derived this conclusion—perhaps because they did not derive it at the time—nor have they cited a single case or authority suggesting that the transaction should have been the least bit helpful. Instead, they rely solely upon the self-serving and conclusory testimony of various Heinz executives, views that simply cannot be squared with the record. Indeed, at the time of the stock transaction, HCC already owned billions of dollars of Heinz-related debt and stock—holdings that apparently gave the Heinz tax professionals no solace. Over more than a decade, those tax professionals argued that HCC should take a more active role in managing its own affairs, have employees and be charged by Heinz for services being rendered—steps that Heinz officials ignored for many years and never fully adopted. Yet, plaintiffs would have this court believe that the same Heinz officials readily embraced a step never mentioned by those same tax professionals to combat a problem that had already matured, and with virtually no hope that the steps taken would have any salutary impact. In light of the objective evidence (or, in plaintiff’s case, the lack thereof), it is far more believable that the Heinz officials never seriously entertained this thought, let alone reasonably so.

This court will not don blinders to the realities of the transaction before it. Stripped of its veneer, the acquisition by HCC of the Heinz stock had one purpose, and one purpose alone—producing capital losses that could be carried back to wipe out prior capital gains. There was no other genuine business purpose. As such, under the prevailing standard, the transaction in question must be viewed as a sham—a transaction imbued with no significant tax-independent considerations, but rather characterized, at least in terms of HCC’s participation, solely by tax-avoidance features. The tax advantage sought by Heinz via this sham must be denied.

[The court further found that after applying “step transaction doctrine” principles, “HCC’s ownership of the Heinz stock must be ignored, with Heinz being viewed as having acquired that stock on the market.”]

Once it is determined that the purchase by Heinz of its stock from HCC did not qualify as a redemption within the meaning of section 317(b), the rest of the pieces of the puzzle readily fall into place. Because, under both the sham and step transaction doctrines, Heinz cannot be viewed as having obtained the stock from HCC in a transaction that qualified as a redemption under section 317(b) of the Code, the transfer of the 3,325,000 shares to Heinz did not cause a dividend to arise under section 302(d) of the Code. As such, the reattribution rules of Treasury Regulation §1.302-2(c) were not triggered here and HCC’s basis in the 175,000 shares it retained was not increased by the cost basis of the shares it relinquished. It follows, *a fortiori*, that the sale of the retained shares did not produce the capital losses claimed, making the loss carrybacks in question inappropriate.

**CONCLUSION**

A Heinz promotion from the late 1950s and early 1960s touted its tomato ketchup by stating—“It’s Red Magic Time!” But no amount of magic, red or otherwise, can hide the meat of the transactions in question, the connective tissues and gristle of which have been revealed by the multi-tined substance-over-form doctrine. *Sans sa sauce*, it becomes plain that plaintiffs’ transaction simply was not “the thing which the statute intended.” *Gregory*, 293 U.S. at 469.…