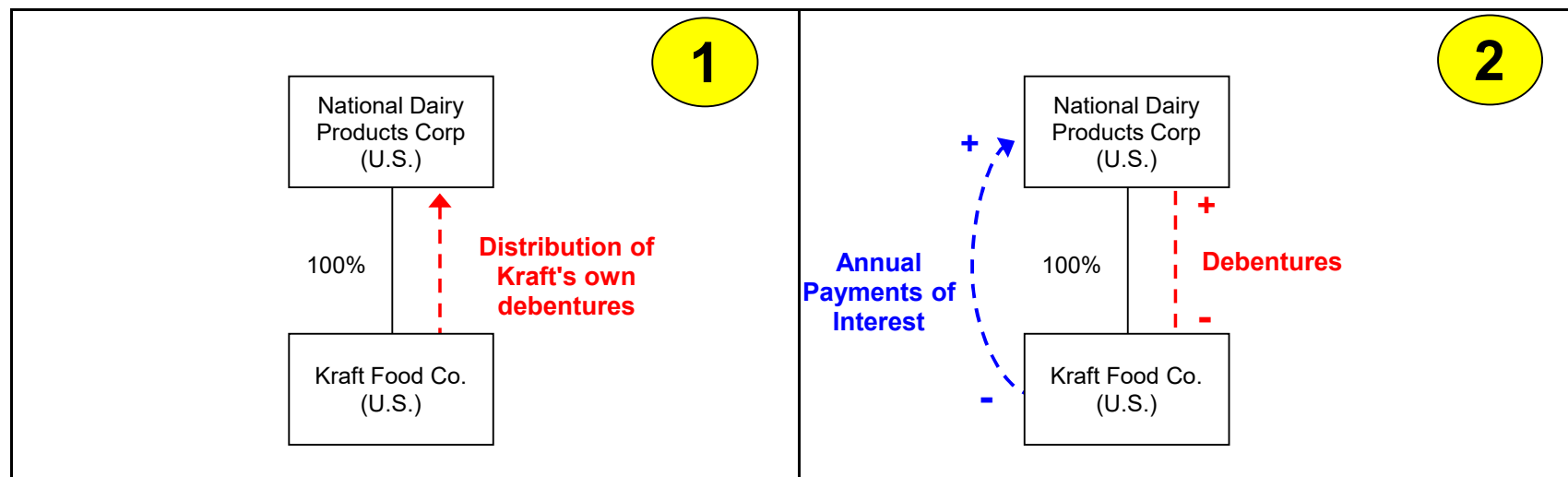


**Dividend of Kraft Debentures**

**Post-Dividend Structure**



Kraft and its parent corporation, National Dairy, had been filing consolidated tax returns. Kraft was profitable. National Dairy operated at a loss. In 1934, Congress abolished consolidated tax returns. In response, Kraft distributed its own debt (debentures) to National Dairy. Annually thereafter, Kraft paid interest to National Dairy, thereby shifting some of Kraft's profits up to National Dairy.

The IRS disallowed Kraft's interest deduction. The Tax Court in an *en banc* ruling upheld the IRS. However, the Second Circuit reversed. The two entities are legally distinct --- Congress chose to tax them as separate entities when it abolished consolidated tax returns. Intercompany transactions between true corporations, conducting their respective businesses as holding company and operating company, must be accorded recognition unless in some way tainted.

The debentures were not hybrid securities --- they were in conventional form and contained all the characteristics of a debt instrument. Kraft was not thinly capitalized. In determining debt-equity ratios, real values rather than artificial par and book values should be applied. Although tax considerations were the primary motivation of the debenture issue, the acts were real and the entities were not shams.