2 T.C. 751 (1943)

When shares of stock are exchanged in a recapitalization and the new shares cannot be specifically identified with particular blocks of old shares, the average cost rule should be used to determine the basis of the new shares.

Summary

Big Wolf Corporation disputed a deficiency assessed by the Commissioner of Internal Revenue regarding personal holding company surtax and penalties. The core issue was whether the corporation realized a capital gain upon receiving liquidating dividends in 1938 from Santa Clara Lumber Co. The corporation's stock in Santa Clara had been acquired through contributions from its principal stockholder, Meigs, who had previously exchanged old shares for new shares in a 1916 recapitalization. Because the specific old shares could not be traced to the new shares, the court held that the average cost rule should be applied to calculate the stock's basis, potentially impacting the determination of a capital gain and the assessed deficiency.

Facts

Big Wolf Corporation received liquidating dividends from Santa Clara stock in 1938.

All 2,064 shares of Santa Clara stock held by Big Wolf were acquired via contributions from its principal stockholder, Ferris G. Meigs, between 1924 and 1930.

Meigs' cost basis for the 2,064 shares totaled $589,774.77, acquired at different times and prices before being contributed to Big Wolf.

In 1916, Santa Clara underwent a recapitalization where Meigs exchanged 2,595 old shares for 2,076 new shares and cash.

Santa Clara made capital distributions on the 2,064 shares held by Big Wolf from 1925 to 1937, totaling $217,603.38.

Procedural History

The Commissioner determined a deficiency in Big Wolf's personal holding company surtax for 1938 and imposed a 25% penalty.

Big Wolf petitioned the Tax Court, contesting the deficiency and penalty.

The Commissioner argued the new shares were identifiable with the old shares, allowing for specific allocation of distributions.

Issue(s)

1. Whether the Commissioner was justified in treating the new shares of Santa Clara stock as specifically identifiable with particular blocks of the old shares when calculating capital gains from liquidating dividends.

Holding

1. No, because there was no practical way to specifically identify which new shares corresponded to which old shares after the 1916 recapitalization, the "average cost rule" should be applied to determine the basis.

Court's Reasoning

The court emphasized the commingling of shares during the 1916 recapitalization, where Meigs surrendered 2,595 old shares evidenced by eleven certificates and received 2,076 new shares evidenced by four certificates. This made identification impossible. The court noted that "certificates are not the only means of identification, but none other is here suggested or relied on."

The court distinguished this case from situations involving reorganizations with a second company, highlighting that this case involved a mere recapitalization.

The court cited with approval the decision in *Arrott v. Commissioner*, 136 F.2d 449, which supported using the average cost rule when specific identification is impossible. As the *Arrott* court observed, "The old shares all have the same exchange value for the new ones no matter what they cost the taxpayer. He gets as much new stock for the share for which he paid $ 80 as he does for the share for which he paid $ 120. The old shares lose their identity when traded for the new…"

The court concluded that applying the average cost rule, where the total cost of all shares is divided by the total number of shares, was the most reasonable approach. The court stated, "the aggregate cost of the eleven blocks of old shares persists and carries over as the basis for the new shares, but on the present facts there is no means of matching the cost of the eleven separate original blocks or certificates with the four new blocks of shares or certificates."

Practical Implications

This case provides a practical rule for determining the basis of stock acquired in a recapitalization when specific identification of old shares to new shares is not possible.

The ruling emphasizes the importance of accurate record-keeping and the ability to trace stock transactions for tax purposes. When records are incomplete or tracing is impossible due to the nature of the transaction (e.g., a commingling of shares), the average cost rule offers a reasonable alternative.

The case clarifies that the Commissioner's allocation of cost does not automatically establish identification; the factual circumstances determine whether specific identification is feasible.

Later cases have cited *Big Wolf* to support the application of the average cost rule in similar situations involving stock reorganizations and distributions where specific identification is not possible.

