5 T.C. 932 (1945)

A transaction where a shareholder exchanges stock and cash for stock in other corporations owned by the original corporation is treated as a sale or exchange of capital assets, not a partial liquidation, if the original corporation retains the acquired stock as treasury stock rather than canceling or redeeming it.

Summary

Maurice Mittelman exchanged his stock in Goetz-Mittelman, Inc. (Michigan), plus cash, for all the stock Michigan owned in I. Miller Stores, Inc. (New York) and Goetz & Mittelman, Inc. (Delaware). The Tax Court addressed whether this was a partial liquidation (taxable at 100%) or a sale/exchange of capital assets (taxable at 50%). The court held it was a sale/exchange because Michigan held Mittelman's stock as treasury stock, not canceling or redeeming it. The court also determined Mittelman's cost basis for computing gain and addressed the taxability of funds directed to New York and Delaware corporations.

Facts

Michigan corporation was in the retail footwear business. Mittelman owned 435 shares of Class B stock in Michigan. Michigan also owned all the stock in New York and Delaware corporations, also in the retail footwear business. Mittelman agreed to exchange his 435 shares in Michigan, plus $18,399.71 in cash, for all of Michigan's stock in New York and Delaware. The amount of cash was determined by a formula to equalize net assets. The agreement stipulated that if Michigan recovered value from certain doubtful assets, half would be paid to Mittelman or his designated corporations (New York/Delaware). The 435 shares Mittelman delivered were not canceled but held as treasury stock.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Mittelman's income tax, arguing the exchange was a partial liquidation. Mittelman contested, claiming it was a sale or exchange of capital assets. The Commissioner amended his answer to increase the deficiency and address the basis calculation and payments to New York/Delaware. The Tax Court heard the case.

Issue(s)

1. Whether the exchange of Mittelman's stock in Michigan for stock in New York and Delaware constituted a distribution in partial liquidation or a sale or exchange of capital assets.
2. What was the proper cost basis of the stock Mittelman transferred, used to compute the gain from the transaction?
3. Whether Mittelman was taxable on $2,872.39 paid to New York and Delaware as his nominees.

Holding

1. No, because Michigan did not cancel or redeem Mittelman's stock but held it as treasury stock.
2. The cost basis was the original cost of Mittelman's shares plus the cash paid, not reduced by a settlement received from an accounting firm for an error in calculating the cash payment.
3. Yes, because Mittelman had the option to receive the funds directly but directed them to New York and Delaware. These are taxable as long-term capital gains.

Court's Reasoning

1. The court relied on the statutory definition of partial liquidation under Section 115 (i), which requires complete cancellation or redemption of stock. The court cited Alpers v. Commissioner, 126 Fed. (2d) 58, distinguishing between acquiring stock for retirement versus holding it as treasury stock. Since Michigan held the stock as treasury stock, the transaction was a sale/exchange, not a partial liquidation. The court emphasized that "The statute applies, not to a distribution in liquidation of the corporation or its business, but to a distribution in cancellation or redemption of a part of its stock."

2. The court rejected the Commissioner's argument that a settlement Mittelman received from the accounting firm should reduce his basis. No new contract was entered into. The settlement was based on the accountant's alleged tort, a separate transaction. Thus, the original cost basis applies.
3. The court applied the principle from Helvering v. Horst, 311 U.S. 112, and Helvering v. Eubank, 311 U.S. 122, that income is taxable to the one who controls its disposition, even if it's directed to another party. Since Mittelman could have received the funds himself, he was taxable on the amounts paid to New York and Delaware.

Practical Implications

This case clarifies the distinction between a partial liquidation and a sale or exchange of stock for tax purposes, focusing on whether the corporation cancels/redeems the acquired stock or holds it as treasury stock. Attorneys must examine the corporation's treatment of the stock. A key takeaway is to examine the final disposition of the exchanged stock. It highlights that settlements from third parties, not directly modifying the original contract terms, don't automatically adjust the cost basis. Furthermore, the case reinforces the principle of constructive receipt: directing income to another doesn't avoid tax liability if the taxpayer had control over its disposition. Subsequent cases and IRS rulings will continue to address fact-specific scenarios in this area, relying on the core principles outlined in Mittelman.

