14 T.C. 947 (1950)

A corporation is not taxed on the sale of assets distributed to its shareholders in liquidation if the shareholders genuinely negotiate and execute the sale independently, and the corporation does not control the proceeds.

Summary

West Coast Securities Co. distributed stock to its shareholders during liquidation. The shareholders then sold the stock to pay off corporate debts secured by the stock. West Coast also settled notes receivable at a discount to generate cash. The Tax Court addressed whether the stock sale was taxable to the corporation and whether the note settlement resulted in a deductible loss. The court held the stock sale was taxable to the shareholders, not the corporation, and the corporation could deduct the loss from the note settlement as a business loss.

Facts

West Coast Securities Co. was dissolving and distributed 47,000 shares of Transamerica stock to its shareholders. The stock was pledged as collateral for West Coast's debts to Transamerica and Bank of America. The shareholders then sold the stock to Transamerica, with the proceeds going directly to pay off West Coast's debts. West Coast also held two promissory notes from J.L. Stewart, secured by second mortgages. To generate cash for liquidation, West Coast settled the notes with Stewart for 60% of their face value after failing to find a third-party buyer. The company sought to deduct the loss from this settlement.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in West Coast's income tax, arguing the stock sale was taxable to the corporation and disallowing the bad debt deduction. West Coast appealed to the Tax Court. The Tax Court consolidated the proceedings involving transferee liability asserted against individual shareholders.

Issue(s)

1. Whether West Coast realized taxable income from the sale of Transamerica stock after distributing the stock to its shareholders in liquidation.
2. Whether West Coast was entitled to a bad debt, capital loss, or ordinary loss deduction for the compromise settlement of the notes.

Holding

1. No, because the sale was made by the shareholders, who independently negotiated and executed the sale after the stock was distributed to them.
2. Yes, because West Coast is entitled to a deduction for a business loss under

Section 23(f) of the Internal Revenue Code arising from the compromise settlement.

Court's Reasoning

Regarding the stock sale, the court distinguished *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), emphasizing that the shareholders, not the corporation, conducted the sale. The court noted that West Coast did not participate in negotiations, and the shareholders acted independently. The court stated that "sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes." The court found a "striking absence" of facts suggesting corporate control over the sale. The court emphasized that the shareholders received a bill of sale transferring title to them. "In substance, what the stockholders did was to sell the stock to Transamerica and direct that the proceeds be applied directly to the obligations of the petitioner… for which the stockholders as transferees were liable."

Regarding the note settlement, the court held that the loss was deductible as a business loss under Section 23(f), not as a bad debt. The court distinguished *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934). The compromise did not stem from a determination of worthlessness, but as a necessary incident of the liquidation. The notes had not matured, and the settlement extinguished all obligations. "By the same token, it is our opinion petitioner has suffered a bona fide loss in the amount of $43,577.50 in its transaction with Stewart. As we have pointed out, the dealings were at arm's length and genuine."

Practical Implications

This case clarifies the circumstances under which a corporation can avoid tax liability on the sale of assets during liquidation. It reinforces that a genuine distribution to shareholders followed by independent shareholder action insulates the corporation from tax. Attorneys advising corporations undergoing liquidation should ensure that shareholders have real control over asset sales and that the corporation avoids direct involvement in negotiations. The case also illustrates that losses from debt settlements during liquidation can be deducted as business losses if the compromise is part of the liquidation plan and not solely based on collectibility.

