## *14 T.C. 1301 (1950)*

Payments received for successfully compelling a corporation's liquidation are taxable as ordinary income, not as a return of capital, when the recipient did not acquire ownership of the corporation's stock.

### Summary

Frank Hodous entered into agreements with Midwest Land Co. stockholders to liquidate the company in exchange for a percentage of their liquidation dividends. The Tax Court addressed whether these payments were taxable as ordinary income or a non-taxable return of capital. The court held that the payments were compensation for services because Hodous never owned the stock and his compensation was contingent on successfully forcing liquidation. Additionally, the court determined deductible business expenses related to Hodous's employment selling the corporation's farm properties, applying the Cohan rule due to incomplete records.

### Facts

Midwest Land Co. was formed to acquire defaulted farm mortgages. Hodous, in 1935, agreed with class A stockholders to investigate Midwest's affairs and attempt liquidation. Between 1935 and 1943, Hodous secured agreements with a majority of class A stockholders, receiving their shares endorsed in blank and later, proxies. The agreements stipulated that if Hodous successfully liquidated Midwest, he would receive a percentage of the liquidation proceeds, typically 35%. Hodous was employed to sell assets of the Midwest Land Co. Liquidating Trust. He received a 5% commission on all sales, plus an expense allowance of $100 per month, and reported this as taxable income.

### Procedural History

The Commissioner of Internal Revenue determined deficiencies in Hodous's income tax for 1943, 1944, and 1945. Hodous petitioned the Tax Court, contesting the Commissioner's determination that payments received from the liquidation were taxable income and disputing the disallowed portions of his claimed business expenses. Hodous later abandoned an issue regarding expenses from grain sales.

### Issue(s)

1. Whether payments received by Hodous in 1943, 1944, and 1945, as a percentage of dividends in liquidation, constitute compensation for services and are thus taxable as ordinary income, or whether these amounts are a return of capital?

2. Whether the Commissioner properly disallowed portions of Hodous's claimed business expenses in 1943, 1944, and 1945?

 

3. Whether Hodous incurred any deductible expenses in connection with taxable income from grain sales in 1945?

## Holding

1. No, because the payments were compensation for services rendered in bringing about the liquidation, and Hodous never owned the stock or acquired a capital asset.

2. Yes, in part. The court determined deductible expenses, but not to the full extent claimed, applying the Cohan rule.

3. Issue was abandoned by the petitioner.

## Court's Reasoning

The court reasoned that Hodous never became the equitable owner of Midwest shares. The agreements only authorized him to vote the shares to compel liquidation. His right to compensation was contingent upon successful liquidation, making it compensation for services, not a return of capital. The court stated, "The agreements with the shareholders of Midwest did not give the petitioner any property right. He was entrusted with the shares solely for the purpose of using the voting control thus amassed to compel the management of Midwest to liquidate." Regarding business expenses, the court acknowledged Hodous's lost records and applied the Cohan rule, estimating deductible expenses based on available evidence, stating, "On the basis of the available evidence, we have, under the principle of the Cohan case… determined that petitioner incurred expenses in 1943 in bringing about the liquidation of Midwest in the amount of $1,200." The court allowed these expenses as nonbusiness expenses incurred for the production of income under Sec. 23 (a) (2), I. R. C..

## Practical Implications

This case clarifies the distinction between compensation for services and a return of capital in the context of corporate liquidations. It highlights that merely holding shares for the purpose of influencing corporate action does not equate to ownership and that compensation for successfully influencing such action is taxable as ordinary income. It also provides an example of the application of the Cohan rule, allowing deductions even with incomplete records, emphasizing the importance of maintaining some form of substantiation. Furthermore, the case emphasizes that expenses incurred to generate income, even if not part of a trade or business, may be deductible.

 