Estate of Franklin Q. Brown v. Commissioner, 9 T.C. 916 (1947)

When a corporation liquidates and distributes assets to shareholders, the shareholder's basis in the distributed assets becomes the new basis for determining gain or loss upon a subsequent sale of those assets, regardless of the original stock basis.

Summary

The Estate of Franklin Q. Brown contested the Commissioner's determination of a capital gain on the sale of a claim against a railroad company. Brown had previously owned preferred shares in a holding company that was liquidated in 1939. As part of the liquidation, Brown received 25 cents per share and an unsecured claim against the New York, New Haven and Hartford Railroad Company. When Brown sold the claim in 1944, the Commissioner determined the basis was the fair market value of the claim at the time of the 1939 liquidation, not the original cost of the preferred shares. The Tax Court upheld the Commissioner's determination, holding that the liquidation established a new basis for the claim.

Facts

Prior to February 19, 1926, Franklin Q. Brown acquired 578 preferred shares of Springfield Railway Companies-1926 at a total cost of $21,231.25.

In 1939, Springfield Railway Companies-1926 was completely liquidated.

As part of the liquidation, Brown received 25 cents per share in cash and an unsecured claim against The New York, New Haven and Hartford Railroad Company.

In 1944, Brown sold the claim against the railroad company for $11,366.44.

Procedural History

The Commissioner determined a deficiency in Brown's income tax for 1944, arguing that Brown realized a capital gain on the sale of the claim against the railroad, based on the fair market value of the claim when it was received during the 1939 liquidation.

The Estate of Franklin Q. Brown petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

Whether the basis for determining gain or loss on the 1944 sale of a claim against a railroad company, which was received as part of a corporate liquidation in 1939, is the fair market value of the claim at the time of the liquidation, or the original cost basis of the stock that was liquidated.

Holding

Yes, the basis is the fair market value of the claim at the time of the liquidation because a complete corporate liquidation is treated as a sale or exchange of the stock, and the shareholder's basis in the assets received is their fair market value at the time of distribution.

Court's Reasoning

The court relied on Section 115(c) of the Internal Revenue Code, which states that amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. The gain or loss is determined under Section 111. This section dictates the "amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

The court determined that the liquidation in 1939 was a taxable event. The preferred shares no longer represented stock but instead evidenced a claim against the guarantor railroad company. Therefore, when Brown sold the "preferred stock" in 1944, he was in fact selling his claim against the railroad company.

The court cited *Robert J. Boudreau, 45 B. T. A. 390, affd. 134 Fed. (2d) 360*, stating,

