16 T.C. 563 (1951)

When a corporation liquidates and distributes assets to its shareholders, the basis of the assets received by the shareholders is their fair market value at the time of distribution, not the original cost of the stock.

Summary

The Estate of Bentley W. Warren contested a tax deficiency assessed by the Commissioner of Internal Revenue. Warren, Sr. held preferred stock in Springfield Railway Companies, which was guaranteed by New York, New Haven and Hartford Railroad Company. Upon liquidation of Springfield Railway Companies, Warren received a small cash distribution and a claim against the guarantor. When Warren sold the claim in 1944, he calculated capital loss using the original stock cost as the basis. The Tax Court sided with the Commissioner, holding that the basis of the claim was its fair market value at the time of the corporate liquidation in 1939, resulting in a capital gain. The court emphasized that the liquidation triggered a taxable event, and the subsequent sale involved a separate asset (the claim).

Facts

Bentley W. Warren acquired 578 shares of preferred stock in Springfield Railway Companies (the holding company) between 1919 and 1926, for $21,231.25. The Consolidated Railway Company (later merged with New York, New Haven and Hartford Railroad Company) guaranteed the preferred stock, including liquidating dividends. In 1939, Springfield Railway Companies liquidated, distributing $0.25 per share in cash and a claim against the guarantor railroad company to its preferred stockholders. Warren received $144.50. In 1944, Warren sold his claim against the railroad company for $11,366.44.

Procedural History

The Commissioner determined a deficiency in Warren’s 1944 income tax, asserting that the sale of the claim resulted in a long-term capital gain, not a loss as Warren claimed. The Commissioner based this on valuing the claim received during the 1939 liquidation. Warren’s estate petitioned the Tax Court, contesting the Commissioner’s adjustment.

Issue(s)

Whether the basis for calculating gain or loss on the sale of a claim against a guarantor railroad, received during the liquidation of a corporation, is the original cost of the stock or the fair market value of the claim at the time of corporate liquidation?

Holding

No, the basis is the fair market value of the claim at the time of corporate liquidation in 1939 because the liquidation was a taxable event that established a new basis for the distributed asset (the claim).

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 are treated as full payment in exchange for the stock. The gain or loss to the distributee is determined under Section 111, which defines the amount realized as the sum of money received plus the fair market value of property (other than money) received. The court found that the 1939 liquidation was a taxable event. Warren received cash and a claim against the railroad company. This claim became a separate asset with a basis equal to its fair market value at the time of the liquidation. When Warren sold the claim in 1944, he was disposing of this new asset, not the original stock. The court cited *Robert J. Boudreau, 45 B.T.A. 390*, affd. 134 Fed. (2d) 360, emphasizing that stockholders are accountable for the difference between the cost basis of their stock and the fair market value of the property received in exchange during liquidation.

Practical Implications

This case clarifies the tax treatment of assets received during corporate liquidations, specifically emphasizing that liquidation creates a new basis for the assets received. Attorneys should advise clients that the basis of assets received in a corporate liquidation is their fair market value at the time of distribution, not the original cost of the stock. This rule applies even if the distributed asset is a contingent claim. This ruling affects how capital gains or losses are calculated when these assets are later sold. It is crucial to accurately determine the fair market value of non-cash assets at the time of liquidation to avoid tax deficiencies later on. Later cases will distinguish based on whether a true liquidation occurred, and whether the distributed asset had an ascertainable fair market value.

