Cousins v. Commissioner, 55 T. C. 620 (1971)

A corporate liquidation is treated as such for tax purposes if the corporation intended to and actually did wind up its affairs, even if followed by the formation of a new corporation.

Summary

In Cousins v. Commissioner, the Tax Court ruled that the complete liquidation of Kind I and subsequent formation of Kind II by the same sole shareholder were separate transactions. The court determined that the assets distributed to the shareholder during Kind I's liquidation were taxable as capital gains, not dividends, because Kind I ceased all business activities and intended to liquidate, despite the later reincorporation. This case clarifies that a true liquidation must show a manifest intent to terminate the corporation's business, and subsequent incorporation does not negate this if not part of the original plan.

Facts

Petitioner, the sole shareholder of Kind I, liquidated the corporation on May 31, 1962, distributing its assets to himself and ceasing all business activities. He operated the former corporate business as a sole proprietorship until November 1962, when he formed Kind II to continue the business due to new financial risks associated with a new product line. The Commissioner argued that the assets retained by the petitioner from Kind I's liquidation should be treated as dividend distributions, either because Kind I was never truly liquidated or because the liquidation and reincorporation constituted a reorganization.

Procedural History

The case was brought before the Tax Court after the Commissioner assessed a deficiency against the petitioner, treating the assets distributed during Kind I's liquidation as dividends. The Tax Court reviewed the case to determine whether the distribution should be taxed as a capital gain or as a dividend.

Issue(s)

1. Whether the distribution of assets from Kind I to the petitioner constituted a liquidation under section 331(a)(1) of the Internal Revenue Code.
2. Whether the liquidation of Kind I and the subsequent formation of Kind II were part of a single reorganization plan under section 368(a)(1)(D) or (F).

Holding

1. Yes, because Kind I intended to and did wind up its affairs, ceasing all business activities and distributing its assets, which satisfied the criteria for liquidation under section 331(a)(1).

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2. No, because there was no intent to reorganize at the time of Kind I's liquidation, and the formation of Kind II was a separate transaction not part of a pre-existing plan.

Court's Reasoning

The court emphasized that liquidation is a factual determination, focusing on whether the corporation intended to and actually did wind up its affairs. The court found that Kind I's cessation of business and distribution of assets demonstrated a clear intent to liquidate, supported by the petitioner's actions in operating the business as a sole proprietorship. The court rejected the Commissioner's arguments, noting that the subsequent incorporation of Kind II did not negate the liquidation because it was not part of a pre-existing reorganization plan. The court cited cases like Genecov v. United States and Beretta v. Commissioner to support its view on the factual nature of liquidation. The court also distinguished this case from scenarios where a formal liquidation is immediately followed by reincorporation, noting that the petitioner's intent and actions in this case indicated separate transactions.

Practical Implications

This decision clarifies that for tax purposes, a corporate liquidation is valid if the corporation genuinely winds up its affairs, even if followed by the formation of a new corporation by the same shareholders. Legal practitioners must ensure that their clients demonstrate a clear intent to liquidate and that subsequent business activities are not part of a pre-existing plan to reorganize. This case impacts how corporate liquidations are structured and documented to achieve favorable tax treatment. It also affects how the IRS assesses whether distributions in such scenarios should be taxed as capital gains or dividends. Subsequent cases like Commissioner v. Berghash and Estate of Henry P. Lammerts have referenced Cousins in analyzing similar liquidation and reorganization scenarios.

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