Morgenstern v. Commissioner, 56 T. C. 44 (1971)

A distribution is not considered a partial liquidation under Section 346 unless it is attributable to the distributing corporation ceasing to conduct its own business.

Summary

In Morgenstern v. Commissioner, the U. S. Tax Court ruled that a distribution of stock from M & S Construction to its shareholders did not qualify as a partial liquidation under Section 346 of the Internal Revenue Code. M & S had distributed stock in its subsidiary, Hughes Hauling Co. , in exchange for a redemption of its own stock. The court held that for a distribution to be considered a partial liquidation, it must be directly attributable to the distributing corporation ceasing to conduct its own business, not that of a subsidiary. Therefore, the distribution was taxable as a dividend, not as a capital gain, impacting how similar corporate distributions should be treated for tax purposes.

Facts

M & S Construction owned 67% of Hughes Hauling Co. , which it had established to handle its hauling business. On July 24, 1963, M & S distributed all its Hughes stock to its shareholders, H. L. Morgenstern and R. J. Schelt, in exchange for a pro rata redemption of M & S stock. Hughes was a separate entity actively conducting its hauling business until its liquidation on August 6, 1963. Morgenstern reported the transaction as a long-term capital gain, but the IRS determined it should be taxed as a dividend.

Procedural History

Morgenstern petitioned the U. S. Tax Court to contest the IRS's determination of a tax deficiency of $8,292. 51 for 1963. The Tax Court, in a decision filed on April 12, 1971, ruled in favor of the Commissioner, holding that the distribution did not qualify as a partial liquidation under Section 346.

Issue(s)

1. Whether the distribution of Hughes Hauling Co. stock by M & S Construction qualified as a partial liquidation under Section 346 of the Internal Revenue Code.

Holding

1. No, because the distribution was not attributable to M & S Construction ceasing to conduct its own business, as required by Section 346(b)(1).

Court's Reasoning

The court emphasized that for a distribution to be considered a partial liquidation under Section 346, it must be directly linked to the distributing corporation ceasing to conduct a trade or business it actively operated. The court rejected the argument that M & S's control over Hughes through majority stock ownership constituted active conduct of Hughes's business. Citing cases like New Colonial Co. v. Helvering, the court upheld the principle of corporate separateness, stating that a close relationship between corporations does not justify disregarding their separate legal identities. The court also referenced the legislative history of Section 346, which indicated that the business terminated must be operated directly by the distributing corporation. Since Hughes operated independently, the distribution of its stock did not qualify as a partial liquidation. The court concluded that the distribution was taxable as a dividend under Section 301.

Practical Implications

This decision clarifies that for a distribution to qualify as a partial liquidation under Section 346, it must be directly tied to the distributing corporation's cessation of its own business operations. Tax practitioners must ensure that any distribution intended to be treated as a partial liquidation is supported by the distributing corporation's direct involvement in the business being terminated. The ruling impacts corporate restructuring strategies, particularly those involving the distribution of subsidiary stock, by requiring a clear connection between the distribution and the cessation of the parent corporation's business. Subsequent cases have referenced Morgenstern in distinguishing between distributions that qualify as partial liquidations and those that do not, reinforcing the importance of corporate separateness in tax law.

