Atwood Grain & Supply Co. v. Commissioner, 60 T. C. 412, 1973 U. S. Tax Ct. LEXIS 110, 60 T. C. No. 45 (1973)

Cooperative participation certificates are equity interests, not debt, and their exchange for preferred stock in a recapitalization does not result in a deductible loss.

Summary

Atwood Grain & Supply Co. sought to deduct a loss from exchanging its participation certificates in United Grain Co. for preferred stock in Illinois Grain Corp. after a merger. The Tax Court ruled that the certificates were equity interests, not debt, and the exchange was a nontaxable recapitalization under IRC Sec. 368(a)(1)(E). Therefore, no loss was deductible. The decision hinged on the certificates' characteristics indicating equity rather than debt, and the exchange not being part of the merger plan but a subsequent recapitalization.

Facts

Atwood Grain & Supply Co. was a patron of United Grain Co. , receiving participation certificates from 1952 to 1957. These certificates were non-interest bearing and redeemable at the discretion of United's board. United merged with Illinois Grain Corp. into New Illinois Grain Corp. Post-merger, New Illinois issued class E preferred stock to holders of United's participation certificates, including Atwood. Atwood sought to deduct the difference between the certificates' face value and the preferred stock's par value as a loss.

Procedural History

The Commissioner disallowed Atwood's deduction, leading to a deficiency notice. Atwood petitioned the U. S. Tax Court, which heard the case and ruled in favor of the Commissioner, determining that the exchange was a nontaxable recapitalization and the certificates represented equity, not debt.

Issue(s)

1. Whether the participation certificates issued by United Grain Co. constituted debt or equity interests.
2. Whether the exchange of participation certificates for preferred stock was part of the merger plan or a separate recapitalization event.
3. Whether Atwood was entitled to deduct any loss realized from the exchange under IRC Sec. 166(a)(2) or as an ordinary loss.

Holding

1. No, because the certificates were redeemable solely at the board's discretion, bore no interest, and were subordinated to other indebtedness, indicating an equity

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interest.
2. No, because the exchange was not contemplated in the merger plan but was a subsequent decision by New Illinois' board, constituting a recapitalization under IRC Sec. 368(a)(1)(E).
3. No, because the exchange was a nontaxable recapitalization, and any loss realized was not recognized under IRC Sec. 354(a)(1).

Court's Reasoning

The court analyzed the certificates' terms, finding multiple indicia of equity, such as discretionary redemption, no interest, subordination to debt, and lack of a fixed maturity date. The court rejected Atwood's argument that the certificates represented debt, citing cases like *Joseph Miele* and *Pasco Packing Association*. The court also determined that the exchange was not part of the merger plan but a recapitalization, as it was not discussed during merger negotiations or included in merger documents. The court relied on *Helvering v. Southwest Consolidated Corp.* to define recapitalization and noted that the exchange reshuffled New Illinois' capital structure. The court concluded that the exchange was a nontaxable reorganization under IRC Sec. 368(a)(1)(E), thus no loss was recognized under IRC Sec. 354(a)(1).

Practical Implications

This decision clarifies that participation certificates in cooperatives are generally treated as equity, not debt, affecting how cooperatives structure their capital and how patrons report income and losses. Practitioners should advise clients that exchanges of such certificates for stock are likely nontaxable recapitalizations, not triggering immediate tax consequences. The ruling impacts how cooperatives plan mergers and recapitalizations, ensuring that any equity interest adjustments are clearly part of the reorganization plan if tax-free treatment is desired. Subsequent cases like *Rev. Rul. 69-216* and *Rev. Rul. 70-298* have applied this principle to similar cooperative reorganizations.

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