Mercantile Bank & Trust Co. v. Commissioner, 60 T. C. 672 (1973)

Payments received in settlement of a lawsuit for failure to deliver promised options may be considered capital gains if they represent additional consideration for the sale or exchange of stock.

Summary

In Mercantile Bank & Trust Co. v. Commissioner, the Tax Court ruled that a $225,000 settlement payment received by trusts for the failure to deliver promised real estate options constituted long-term capital gains. The trusts were minority shareholders in Material Service Corp. , which merged with General Dynamics. They contested the valuation of assets excluded from the merger and were promised options on real estate as additional consideration for their shares. When the options were not delivered, they sued and settled. The court found the settlement payment was additional consideration for their stock, thus qualifying as capital gain. However, accrued dividends received upon redemption of General Dynamics stock were ruled to be ordinary income.

Facts

The Gidwitz Family Trust and Michael Gidwitz II Trust, managed by Mercantile Bank & Trust Co. , owned shares in Material Service Corp. (Material Service). In 1959, Material Service planned to merge with General Dynamics, and certain assets were to be distributed to Empire Properties, controlled by the Crown family, in redemption of their shares. The trusts believed these assets were undervalued and demanded to participate in the redemption or block the merger. Henry Crown, chairman of Material Service, orally agreed to grant the trusts options to purchase two properties as additional consideration for their shares, but these options were never delivered. The trusts sued Henry Crown and his attorney for breach of this agreement, eventually settling for $225,000. The trusts reported this settlement as capital gains on their 1966 tax returns, while the IRS classified it as ordinary income. Additionally, the trusts received payments from General Dynamics upon redemption of their convertible preference stock, part of which included accrued dividends.

Procedural History

The IRS issued deficiency notices to the trusts for 1966, asserting that the settlement payment should be taxed as ordinary income and that accrued dividends from the redemption of General Dynamics stock were also taxable as ordinary income. The trusts petitioned the Tax Court for a redetermination of these deficiencies. The court held hearings and issued its decision in 1973.

Issue(s)

1. Whether the $225,000 received by the trusts in settlement of a lawsuit for failure

to deliver options constitutes gain from the sale or exchange of a capital asset.
2. Whether the portion of the redemption payment for General Dynamics convertible preference stock representing accrued dividends is taxable as a dividend under section 301 of the Internal Revenue Code or as a capital gain under section 302(a).

Holding

1. Yes, because the settlement payment was found to be additional consideration for the trusts' shares in Material Service, making it a capital gain.
2. No, because the accrued dividends received upon redemption of General Dynamics stock were taxable as dividend income under section 301 of the Internal Revenue Code.

Court's Reasoning

The court analyzed the settlement payment's nature, finding it to be additional consideration for the trusts' shares in Material Service, based on the detailed testimony of key witnesses and the context of the merger negotiations. The court referenced prior cases like David A. DeLong, where payments made to secure a minority shareholder's approval for a merger were treated as part of the total consideration for the stock sale, thus qualifying as capital gains. The court distinguished this from the accrued dividends issue, following its precedent in Arie S. Crown, where similar accrued dividends were ruled to be ordinary income under section 301. The court emphasized that the taxability of settlement payments hinges on the origin and character of the underlying claim, which in this case stemmed from the trusts' stock value dispute in the merger.

Practical Implications

This decision clarifies that settlement payments arising from disputes over stock value in corporate transactions can be treated as capital gains if they are found to be additional consideration for the stock. Attorneys advising clients in similar situations should carefully document the nature of any settlement to support a capital gain classification. The ruling does not change the treatment of accrued dividends upon stock redemption, which remain taxable as ordinary income. Businesses involved in mergers should be aware that promises made to minority shareholders to facilitate a merger can have significant tax implications if not fulfilled. Subsequent cases have referenced this decision when analyzing the tax treatment of settlement payments in corporate disputes.