John T. Stewart III Trust v. Commissioner, 63 T. C. 682 (1975)

Mortgage servicing contracts qualify as “property” under Section 337, and their sale during liquidation does not result in an assignment of income if the income was not earned prior to the sale.

Summary

National Co. , a mortgage banking business, sold all its assets, including mortgage servicing contracts, to First National Bank as part of its liquidation. The Tax Court held that the gain from the sale of these contracts was eligible for nonrecognition under Section 337, as they constituted “property” and no income was assigned since the fees were earned post-sale by First National. Additionally, legal and accounting fees incurred during the sale were not deductible as business expenses. This ruling clarifies the scope of Section 337 and the assignment-of-income doctrine in corporate liquidations.

Facts

National Co. of Omaha, engaged in mortgage banking and insurance, decided to liquidate and sell its assets to First National Bank of Omaha in February 1965. The sale included mortgage servicing agreements, which were contracts to perform services on mortgages sold to institutional investors. These agreements were terminable at will by the investors and required National Co. to collect payments, manage escrow accounts, and perform other services. After the sale, First National continued these services using National Co. ‘s former employees and facilities.

Procedural History

The Commissioner determined deficiencies in National Co. ‘s federal income taxes for the years ending October 31, 1962, and October 31, 1965, asserting that the gain from the sale of mortgage servicing agreements should be recognized. National Co. ‘s shareholders, as transferees, contested this at the Tax Court. The court ruled in favor of the petitioners on the nonrecognition of gain under Section 337 but against them regarding the deductibility of legal and accounting fees.

Issue(s)

1. Whether mortgage servicing agreements sold by National Co. to First National Bank during liquidation constitute “property” under Section 337, thereby entitling the gain to nonrecognition treatment?
2. Whether the sale of these agreements resulted in an assignment of income?
3. Whether legal and accounting fees incurred in connection with the asset sale are deductible as ordinary and necessary business expenses?

Holding

1. Yes, because mortgage servicing agreements are assets of the corporation and do not fall within the exclusions listed in Section 337(b).
2. No, because the income from the servicing agreements was not earned by National Co. prior to the sale; it was earned by First National after the sale.
3. No, because legal and accounting fees incurred in connection with the sale of assets during liquidation are not deductible as ordinary and necessary business expenses under the Eighth Circuit's ruling in United States v. Morton.

Court's Reasoning

The court's reasoning focused on the interpretation of "property" under Section 337, which includes all assets except those specifically excluded, such as inventory and certain installment obligations. The court rejected the Commissioner's argument that only capital assets qualified as property, citing Section 1. 337-3(a) of the Income Tax Regulations and the Sixth Circuit's decision in Midland-Ross Corp. v. United States. The court also analyzed the assignment-of-income doctrine, concluding that no income was assigned because the fees were earned by First National after it assumed the servicing obligations. The court distinguished cases where income had been fully earned before the assignment, emphasizing that National Co. had not performed services entitling it to fees at the time of sale. For the deductibility of legal and accounting fees, the court followed the Eighth Circuit's precedent, ruling that such expenses in liquidation are not deductible.

Practical Implications

This decision expands the scope of Section 337 to include mortgage servicing contracts as property, benefiting corporations in similar liquidation scenarios by allowing nonrecognition of gains from such sales. It clarifies that the assignment-of-income doctrine does not apply unless the income was earned before the sale, providing guidance on structuring liquidations to avoid tax recognition. The ruling on the nondeductibility of liquidation-related fees reinforces the need for careful tax planning in liquidations. Subsequent cases, such as Of Course, Inc. , have followed this precedent, further solidifying its impact on corporate liquidation tax strategies.