Prescott v. Commissioner, 66 T. C. 128 (1976)

Termination of a Section 1361 election to be taxed as a corporation results in a deemed corporate liquidation for tax purposes.

Summary

Edward J. Prescott elected to have his sole proprietorship taxed as a corporation under Section 1361 in 1954. This election terminated by operation of law on January 1, 1969, due to legislative changes. The U. S. Tax Court held that this termination should be treated as a complete corporate liquidation, making the assets received taxable to Prescott. The court also ruled that no portion of the gain was exempt due to the nature of the assets, and upheld the negligence penalty for failing to report the income from the deemed liquidation.

Facts

Edward J. Prescott operated a securities business as a sole proprietorship under the name E. J. Prescott & Co. In 1954, he elected to be taxed as a corporation under Section 1361 of the Internal Revenue Code. This election remained in effect until January 1, 1969, when it terminated by operation of law under Section 1361(n)(2), following the repeal of subchapter R. At the time of termination, the business had assets valued at $1,481,159. 90 and liabilities of $947,605. 85, resulting in a net value of $533,554. 05. Prescott did not file a corporate tax return for 1969 and failed to report any income from the deemed liquidation on his personal return.

Procedural History

The Commissioner determined a deficiency in Prescott's 1969 federal income tax and assessed an addition to tax under Section 6653(a) for negligence. Prescott petitioned the U. S. Tax Court to contest these determinations. The Tax Court held that the termination of the Section 1361 election was to be treated as a corporate liquidation, that no portion of the gain was exempt from tax, and that the negligence penalty was applicable.

Issue(s)

1. Whether the termination of a Section 1361 election by operation of law on January 1, 1969, should be treated as a corporate liquidation under Section 331.
2. Whether any portion of the gain realized on such liquidation is exempt from taxation due to the character of the assets deemed distributed.
3. Whether the negligence penalty under Section 6653(a) is applicable to the petitioner for failing to report the income from the liquidation.

Holding

1. Yes, because the legislative history and regulations clearly state that the

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termination of a Section 1361 election results in a deemed corporate liquidation for tax purposes.
2. No, because the assets received in liquidation do not retain the tax-exempt character of the underlying municipal bonds.
3. Yes, because the petitioner failed to meet his burden of proof in showing that he was not negligent in failing to report the income from the liquidation.

Court's Reasoning

The court relied on the legislative history of the 1966 amendments to Section 1361, which explicitly stated that termination of the election would be treated as a complete corporate liquidation. This was further supported by the Treasury regulations, which were deemed consistent with congressional intent. The court rejected Prescott's argument that the gain on liquidation should be exempt due to the tax-exempt nature of the municipal bonds held by the business, reasoning that the assets received in liquidation were not interest but a return on investment. The court also found that Prescott was liable for the negligence penalty, as he failed to provide evidence that his failure to report the income was not due to negligence or intentional disregard of rules and regulations.

Practical Implications

This decision clarifies that the termination of a Section 1361 election results in a taxable event, treated as a corporate liquidation. Taxpayers must be aware of the tax implications of such terminations and plan accordingly, including considering the potential for gain recognition on the deemed distribution of assets. The ruling also underscores that the tax-exempt status of certain assets does not automatically carry over to the shareholder upon liquidation. Practitioners should advise clients to report income from such terminations accurately to avoid negligence penalties. This case has been cited in subsequent decisions involving the tax treatment of business reorganizations and terminations of special tax elections.

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