McCormac v. Commissioner, 67 T. C. 955 (1977)

Distributions received by shareholders post-liquidation, representing income from trust assets assigned in lieu of stock, are taxable as ordinary income, not capital gains.

Summary

In McCormac v. Commissioner, shareholders of a dissolved corporation received assignments of beneficial interest in a trust in exchange for their stock, pursuant to a section 333 liquidation. The trust, funded by pre-need funeral sales, generated income from investments which was previously distributed to the corporation and reported as dividends and interest. Post-liquidation, the shareholders argued these distributions should be taxed as capital gains. The court held that these payments were ordinary income, following precedent from Mace Osenbach and Ralph R. Garrow, as the shareholders merely substituted for the corporation's right to receive trust income.

Facts

Hawaiian Guardian, Ltd. sold pre-need funerals, retaining 25% of the contract price and placing 75% in trust with Bishop Trust Co. , Ltd. The trust's income was paid quarterly to Guardian, who reported it as dividend and interest income. In 1969, Guardian was liquidated under section 333, and shareholders, including Scott McCormac and Eleanor Lynn McKinley, received assignments of Guardian's beneficial interest in the trust in exchange for their stock. Post-liquidation, they received trust income, claiming it as capital gains.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes, treating the trust income as ordinary income. The petitioners filed for redetermination with the United States Tax Court, which upheld the Commissioner's determination.

Issue(s)

1. Whether the quarterly trust income received by the shareholders after the liquidation of Guardian under section 333 is taxable as ordinary income rather than capital gain?

Holding

1. Yes, because the shareholders received the trust income in lieu of the corporation's right to receive such income, which was previously reported as ordinary income by the corporation.

Court’s Reasoning

The court reasoned that the shareholders merely substituted for the corporation’s right to receive trust income, which was previously reported as ordinary income by Guardian. The court relied on Mace Osenbach and Ralph R. Garrow, which established that post-liquidation collections from assigned assets are taxable as ordinary income, not capital gains. The court rejected the petitioners’ argument that the beneficial interest in the trust was sui generis or had no ascertainable fair market value, noting that such a claim was not substantiated with proof. The court emphasized that the Ninth Circuit, to which the case would be appealed, had previously upheld similar decisions, binding the Tax Court under Golsen.

Practical Implications

This decision clarifies that when a corporation liquidates under section 333 and assigns its rights to receive income from a trust to its shareholders, those subsequent payments remain ordinary income. Practitioners must carefully evaluate the nature of assets distributed in liquidation to advise clients accurately on tax implications. The ruling reinforces the principle that the character of income does not change merely because of a change in recipient due to liquidation. This case has implications for structuring corporate liquidations and trust arrangements, particularly in industries like pre-need funeral sales, where trust income is a significant component of business operations.

