1 T.C. 872 (1943)

A transfer of property pursuant to a bankruptcy reorganization can qualify as a tax-free reorganization, allowing the transferee to use the transferor's basis for depreciation, even if the transferee assumes reorganization expenses and the transferor's shareholders are eliminated, provided the creditors effectively controlled the disposition of the property.

Summary

Alcazar Hotel, Inc. sought to use the basis of its predecessor corporation, Heights Hotel Co., for calculating depreciation deductions after a reorganization under Section 77B of the National Bankruptcy Act. The Tax Court held that the reorganization qualified as tax-free, allowing Alcazar to use Heights' basis. The court reasoned that the creditors of Heights effectively controlled the company due to its insolvency, satisfying the continuity of interest requirement. The assumption of reorganization expenses by Alcazar did not disqualify the reorganization. Furthermore, the exchange of debt for stock did not constitute a cancellation of indebtedness requiring a reduction in basis.

Facts

Heights Hotel Co. acquired property, assuming first mortgage bonds. It later executed a second mortgage note. Facing financial difficulties, Heights underwent reorganization proceedings under Section 77B of the National Bankruptcy Act. The reorganization plan involved forming a new corporation, Alcazar Hotel, Inc., to which Heights would transfer all its assets. Bondholders and noteholders of Heights would receive stock in Alcazar, while the old shareholders would receive nothing. Alcazar assumed certain liabilities and reorganization expenses. The Heights Hotel Co.'s basis in the buildings and equipment was $590,900.36 and $24,268.60, respectively.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Alcazar's income tax, arguing that Alcazar should use the fair market value of the property at the time of acquisition, rather than the predecessor's basis, for depreciation calculations. Alcazar petitioned the Tax Court, contesting the Commissioner's determination.

Issue(s)

1. Whether the transfer of property from Heights Hotel Co. to Alcazar Hotel, Inc. pursuant to a Section 77B reorganization qualifies as a tax-free reorganization under Section 112(g)(1)(B) of the Revenue Act of 1936 (as amended) or the Internal Revenue Code (as amended)?

2. Whether the acceptance of Alcazar's stock by Heights' noteholders in satisfaction

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of their claims resulted in a cancellation of indebtedness under Section 270 of the National Bankruptcy Act, requiring a reduction in basis?

Holding

1. Yes, because the creditors of Heights effectively controlled the disposition of its property due to its insolvency, thus satisfying the continuity of interest requirement for a reorganization. The assumption of reorganization expenses by Alcazar did not disqualify the transaction.

2. No, because the exchange of debt for stock constituted a continuation of the obligation in another form, not a cancellation of indebtedness.

Court's Reasoning

The Tax Court reasoned that the transfer qualified as a tax-free reorganization under Section 112(g)(1)(B) of the Revenue Act of 1936, as amended. The court acknowledged the 1939 amendment to the statute, which clarified that the assumption of a liability by the acquiring corporation would be disregarded when determining if the exchange was solely for voting stock. The court relied on *Helvering v. Alabama Asphaltic Limestone Co.*, stating that the elimination of the transferor's stockholders did not disqualify the transaction as a reorganization because the creditors effectively controlled the property. Although there was no direct proof of insolvency, the court inferred it from the fact that the old shareholders received nothing in the reorganization. The court also cited *Claridge Apartments Co.*, stating that the assumption of reorganization expenses by the transferee does not disqualify the transaction. Finally, the court held that the exchange of debt for stock did not constitute a cancellation of indebtedness under Section 270 of the National Bankruptcy Act. It reasoned that the debt was transformed into a capital stock liability, not forgiven, citing *Capento Securities Corporation*.

Practical Implications

Alcazar Hotel provides guidance on tax implications of corporate reorganizations in bankruptcy. It clarifies that a transfer can qualify as a tax-free reorganization even when the old shareholders are eliminated and the creditors take control. This is critical for preserving the tax basis of assets. This case confirms that assumption of reorganization expenses doesn't necessarily disqualify a transaction and that exchanging debt for stock isn't a cancellation of debt. Later cases rely on *Alcazar Hotel* to determine if a transferor was indeed insolvent and whether continuity of interest was met through creditor control. Attorneys structuring bankruptcy reorganizations need to carefully consider these factors to determine the tax consequences for all parties involved.

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