3 T.C. 1277 (1944)

A corporate reorganization where a new corporation acquires substantially all the properties of another corporation in exchange for voting stock and securities can qualify as a tax-free reorganization under Section 112 of the Revenue Act, provided there is a continuity of interest between the old and new corporations.

Summary

New Jersey Mortgage & Title Co. (New Jersey) acquired the assets of Guarantee Mortgage & Title Insurance Co. (Mortgage Co.) and its subsidiary through a reorganization plan approved by a New Jersey court. Mortgage Co. was in financial distress and underwent rehabilitation proceedings. The plan involved New Jersey issuing bonds and preferred stock to Mortgage Co.'s bondholders and common stock to its stockholders. The Tax Court addressed whether this constituted a tax-free reorganization, focusing on whether the exchange was solely for stock or securities and whether there was a continuity of interest. The court held that it was a tax-free reorganization, allowing New Jersey to use the Mortgage Co.'s basis for its assets.

Facts

- Guarantee Mortgage & Title Insurance Co. (Mortgage Co.) faced financial difficulties and was unable to meet its obligations.
- Mortgage Co. filed a petition for reorganization under New Jersey law.
- A plan was approved by the Chancery Court calling for the formation of New Jersey Mortgage & Title Co. (New Jersey).
- New Jersey issued bonds to Mortgage Co.'s bondholders, preferred stock for unpaid interest, and common stock to Mortgage Co.'s stockholders.
- New Jersey assumed and paid Mortgage Co.'s accounts payable, taxes, and reorganization expenses.

Procedural History

- The Commissioner of Internal Revenue determined a deficiency in New Jersey's income tax, arguing the reorganization was taxable.
- New Jersey initially argued it was a new entity entitled to establish its own cost basis for assets.
- After the Supreme Court's decision in *Helvering v. Southwest Consolidated Corporation*, both parties shifted their positions, with New Jersey arguing for a tax-free reorganization and the Commissioner arguing against it.
- The Tax Court considered the issue based on stipulated facts and oral evidence.

Issue(s)

1. Whether the acquisition of Mortgage Co.'s assets by New Jersey constituted a tax-free reorganization under Section 112(g)(1)(B) of the Revenue Act of 1934,

as amended.
2. Whether there was sufficient continuity of interest between Mortgage Co. and New Jersey to qualify the transaction as a tax-free reorganization.

Holding

1. Yes, because New Jersey acquired substantially all of Mortgage Co.'s property solely in exchange for its voting stock and securities, meeting the literal requirements of Section 112(g)(1)(B).
2. Yes, because despite the financial difficulties of Mortgage Co., there was sufficient continuity of proprietary interest through the bondholders and stockholders of the old company becoming security holders and stockholders of the new company.

Court's Reasoning

The Tax Court reasoned that the acquisition met the statutory definition of a reorganization under Section 112(g)(1)(B). While the Supreme Court in *Helvering v. Southwest Consolidated Corporation* emphasized that "'solely' leaves no leeway," the Tax Court distinguished this case by noting that New Jersey's assumption and payment of Mortgage Co.'s unsecured debts were merely the discharge of existing liabilities and not additional consideration. The issuance of new bonds with modified terms (interest rate, maturity date) did not negate the assumption of debt. Crucially, the court emphasized the continuity of interest. The bondholders and stockholders of the old company maintained a proprietary interest in the new company, albeit with temporary control shifting to the bondholders through voting preferred stock. The court cited *John A. Nelson Co. v. Helvering*, stating that continuity of interest does not require continuity of control. Since the exchange qualified as a reorganization under Section 112(b)(4), New Jersey was entitled to use the Mortgage Co.'s basis for the acquired assets under Section 113(a)(6).

Practical Implications

This case illustrates the application of the tax-free reorganization provisions in the context of financially troubled companies. It clarifies that the assumption of existing liabilities by the acquiring corporation does not necessarily disqualify a transaction from being a tax-free reorganization. It underscores the importance of continuity of interest, even when control shifts temporarily due to financial restructuring. For practitioners, this case provides guidance on structuring reorganizations involving distressed entities to achieve tax-free status, emphasizing the need to maintain a sufficient level of equity and debt participation by the old company's stakeholders in the new company. Later cases may distinguish this ruling based on the degree of change in proprietary interests and the specific nature of consideration beyond stock and securities.

