6 T.C. 194 (1946)

When a corporation acquires property in exchange for stock, the basis of the property for determining loss or equity invested capital is the cost of the property (i.e., the fair market value of the stock), unless the acquisition qualifies as a tax-free reorganization under specific provisions of the Internal Revenue Code where control remains with the transferor.

Summary

Independent Oil Co. (petitioner) acquired assets from another company (the old company) in exchange for its stock. The old company then transferred most of that stock to Vacuum Oil. The Tax Court addressed whether the petitioner's basis in the acquired assets should be its cost (fair market value of its stock) or the old company's basis. The court held that because the old company did not maintain control of the petitioner immediately after the exchange due to the prearranged transfer to Vacuum Oil, the petitioner's basis was its cost, not the transferor's basis. This determination impacted the calculation of equity invested capital for excess profits tax purposes.

Facts

The old company, Independent Oil Co., agreed with Vacuum Oil to form a new company (the petitioner). Pursuant to the agreement: 1) The old company transferred substantially all its assets to the petitioner in exchange for all the petitioner's stock. 2) The old company immediately transferred 75% of the petitioner's stock to Vacuum Oil, with Vacuum holding an option on the remaining 25%. 3) Vacuum Oil issued its stock to the old company in exchange for the 75% of the petitioner's stock. The old company then distributed the Vacuum Oil stock to its shareholders and dissolved. The agreement was structured so that Vacuum would obtain an interest in the business without taking on the old company's undisclosed liabilities. The value of the petitioner's stock at the time was $3,156,558.67, while the old company's adjusted basis in the transferred assets was $1,223,225.35.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the petitioner's excess profits tax for 1940. The dispute centered on the proper calculation of the excess profits credit using the invested capital method. The Commissioner argued for using the old company's basis in the assets, which would result in a lower excess profits credit and thus a higher tax liability. The Tax Court ruled in favor of the petitioner, allowing it to use the fair market value of its stock (i.e., its cost) as the basis for the assets.

Issue(s)

Whether, in computing the petitioner's excess profits credit by the invested capital

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method, the amount to be included in equity invested capital for "property paid in for stock" is (a) the cost of said property, or (b) the basis of that property in the hands of the petitioner's transferor.

Holding

No, because the old company (transferor) did not maintain control of the petitioner (transferee) immediately after the exchange, and therefore, the transaction did not qualify under the exceptions outlined in Internal Revenue Code Sections 113(a)(7) and 113(a)(8) that would require using the transferor's basis.

Court's Reasoning

The court relied on Internal Revenue Code Section 718(a)(2), which defines equity invested capital as including property paid in for stock at its basis (unadjusted) for determining loss upon sale or exchange. Normally, under Section 113(a), this basis is the cost of the property. However, exceptions exist in Sections 113(a)(7) and 113(a)(8) for certain corporate reorganizations where the transferor's basis is used if the transferor maintains control. The court found that the old company did not maintain control of the petitioner immediately after the exchange because, as part of a prearranged plan, it transferred the majority of the petitioner's stock to Vacuum Oil. The court emphasized that "The entire operation was in accordance with a prearranged plan. The separate transfers were but component steps of a single transaction. It is well settled that the transaction must be viewed as a whole." Because the old company only momentarily held the stock before transferring it to Vacuum, it did not have the requisite control for the exception to apply. The court distinguished *Commissioner v. First National Bank of Altoona*, noting that case did not involve the specific question of basis under Section 113 in the same factual context.

Practical Implications

This case illustrates the importance of analyzing the entire transaction when determining the tax consequences of a corporate reorganization. The "step transaction doctrine" prevents taxpayers from artificially separating integrated transactions to achieve a desired tax result. The case emphasizes that for a transferor's basis to carry over to the transferee corporation, the transferor must maintain control immediately after the exchange, considering any prearranged agreements to transfer stock. This decision clarifies how to determine the basis of assets acquired in complex corporate restructurings, particularly when a pre-existing agreement dictates the subsequent transfer of stock. Later cases applying this ruling would scrutinize the timing and intent behind stock transfers following an initial exchange of property for stock.

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