Reilly Oil Co. v. Commissioner, 18 T.C. 90 (1952)

For a corporate acquisition to qualify as a tax-free reorganization under the 1938 Revenue Act, at least 50% of the interest or control in the acquired property must remain in the same persons who held interest or control before the transfer; mere creditor status is insufficient.

Summary

Reilly Oil Company sought to use the cost basis of its predecessor, American company, for depreciation and depletion purposes, arguing its acquisition was a tax-free reorganization. The Tax Court disagreed, finding that less than 50% of the interest or control in the acquired property remained with the former owners or creditors after the transfer. The court reasoned that the prior lien notes issued to American's creditors did not constitute an ownership interest, and the substantial stockholding of Weatherby, who was merely a stockholder of American and contributed services to Reilly, could not be combined with the creditors' interests to meet the 50% threshold. Therefore, Reilly could not use American's basis.

Facts

- American company underwent receivership and its assets were sold.
- Weatherby formed Reilly Oil Company to acquire American's assets.
- Reilly issued prior lien notes to American's creditors or their assignees, and to subscribers of new money.
- Reilly also issued common stock, with a large portion going to Weatherby (875,000 shares out of 1,093,750) and a smaller portion to American's creditors as a bonus (approximately 73,509 shares).
- Weatherby received a large block of stock for services rendered in the reorganization, independent of any prior interest in American.

Procedural History

Reilly Oil Co. petitioned the Tax Court to challenge the Commissioner's determination of its basis for depreciation and depletion. The Commissioner argued Reilly's basis should be its cost, not the cost to American. The Tax Court ruled in favor of the Commissioner, denying Reilly the use of American's basis.

Issue(s)

1. Whether Reilly Oil Company acquired the properties of American in connection with a "reorganization" as defined by the Revenue Act of 1928 or 1938?
2. Whether, immediately after the transfer, an interest or control in such property of 50 percent or more remained in the same persons or any of them, who had an interest or control in American, thereby entitling Reilly to use American's cost basis for depreciation and depletion under Section 113(a)(7) of the Revenue Act of 1938?

Holding

1. The court found it unnecessary to decide if the transaction was a reorganization.
2. No, because the prior lien notes issued to creditors did not constitute an equity "interest or control," and Weatherby's stock ownership could not be attributed to the former creditors to meet the 50% threshold for continuity of interest.

Court's Reasoning

The court focused on whether 50% or more of the "interest or control" remained in the same persons after the transfer. It acknowledged that the statute doesn't require the interest to remain in *all* the same persons, only that the *statutory quantum* remains in *any* of them. However, it found that the prior lien notes issued to American's creditors merely provided creditor rights, not an ownership interest. The court quoted Mertens, Law of Federal Income Taxation, noting that the term "interest" in the statute refers to a right "in the nature of ownership, and not the limited rights of creditors." The court further reasoned that Weatherby's substantial stockholding could not be combined with the creditors' interests because Weatherby received his stock for services and promotional activities, not because of any prior ownership in American. Thus, continuity of interest was not met.

The court distinguished Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, noting that the rights of beneficial ownership of American's stockholders were wiped out by the receivership sale and superseded by the rights of creditors.

Practical Implications

This case clarifies the "continuity of interest" requirement in tax-free reorganizations. It emphasizes that creditor status alone is insufficient to demonstrate a continuing ownership interest. The case highlights the importance of distinguishing between debt and equity when analyzing corporate restructurings for tax purposes. Attorneys structuring reorganizations must carefully track the equity ownership before and after the transaction to ensure that the requisite percentage of ownership remains in the same hands. This case serves as a reminder that the form of consideration matters; simply converting debt to new debt in a reorganized entity does not necessarily preserve the tax benefits of a reorganization.