Four Twelve West Sixth Co. v. Commissioner, 7 T.C. 26 (1946)

When a corporation acquires property in a reorganization but the transferors do not maintain 50% control, the corporation's basis for depreciation is the fair market value of the property at the time of acquisition, not the transferor's basis.

Summary

Four Twelve West Sixth Co. acquired property through a reorganization where bondholders of a defaulting corporation transferred assets in exchange for stock, but a separate investor group obtained majority control. The Tax Court addressed the issue of whether the new company could use the transferor's (high) basis for depreciation or if it was limited to its own cost basis. The court held that because the original bondholders did not retain 50% control after the reorganization, the company's depreciation basis was the fair market value of the assets when acquired. The court also determined that collections on accounts receivable with no cost basis constituted income.

Facts

Detwiler Corporation defaulted on bonds secured by a leasehold and a 14-story office building. Bondholders formed a protective committee and developed a reorganization plan with S. Waldo Coleman. A new corporation, Four Twelve West Sixth Co. (the petitioner), was formed. The bondholders' committee foreclosed on the property, bid $44,000, and transferred the assets to the new corporation for 49% of its common stock. Coleman's group invested $60,000 for preferred stock and 51% of the common stock. The petitioner initially recorded low values for the assets on its books but later increased them to reflect fair market value based on an appraisal.

Procedural History

The Commissioner determined deficiencies in the petitioner's income and excess profits taxes, arguing that the petitioner's basis for depreciation should be based on its cost, not the fair market value. The Commissioner increased income by the amount of collections on certain receivables and disallowed portions of the claimed depreciation deduction. The Four Twelve West Sixth Co. petitioned the Tax Court for review.

Issue(s)

1. Whether the acquisition of property by the petitioner constituted a reorganization within the meaning of Section 112(g)(1)(B) of the Revenue Act of 1934.
2. If a reorganization occurred, whether the petitioner is entitled to use the transferor's basis for depreciation under Section 113(a)(7) of the Revenue Act of 1934.
3. What is the proper basis for depreciation of the acquired assets.

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4. Whether collections on accounts and notes receivable acquired in the reorganization constitute taxable income.

Holding

1. Yes, because the bondholders of Detwiler exchanged all of its properties solely for a part of petitioner's voting stock.
2. No, because the bondholders did not retain 50% control of the property after the reorganization.
3. The proper basis is the fair market value of the assets at the time of acquisition, because the transferor's basis is unavailable due to the lack of control.
4. Yes, because those assets had a zero basis.

Court's Reasoning

The Tax Court found that a reorganization occurred under Section 112(g)(1)(B) of the Revenue Act of 1934, as the bondholders exchanged Detwiler's properties for the petitioner's voting stock. However, Section 113(a)(7), which allows the transferor's basis to be used, requires that the transferors retain at least 50% control after the transfer. Because the Coleman interests acquired majority control (51% of common stock and all preferred stock with equal voting rights), the bondholders did not maintain the required control. The court stated, "After the reorganization the bondholders of Detwiler held only 49 per cent of the common stock. The Coleman interests upon completion of the plan of reorganization held 51 per cent of the common and all outstanding preferred stock, which had equal voting rights with common. It can not be said, therefore, that the same persons or any of them held an interest or control in the property of 50 per cent or more." Consequently, the petitioner could not use Detwiler's basis. The court determined the petitioner's basis was its cost, measured by the fair market value of the stock exchanged for the assets. Since the circumstances of the stock sale to Coleman were not determinative of fair market value, the court equated the value of the stock to the stipulated fair market value of the assets acquired. Collections on receivables with zero basis were deemed income, citing *Michael Carpenter Co. v. Commissioner*, 136 Fed. (2d) 51.

Practical Implications

This case illustrates the importance of maintaining control in a reorganization to preserve a favorable basis for depreciation. Attorneys structuring corporate reorganizations must carefully consider the control requirements of Section 113(a)(7) (and its successor provisions) to ensure the desired tax consequences. The case also reinforces the principle that assets with a zero basis generate income when collected. *Four Twelve West Sixth Co.* is frequently cited in cases involving basis determinations following corporate reorganizations and serves as a reminder that form must align with substance to achieve intended tax outcomes. It is

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particularly important when outside investors are brought into a restructuring and the original owners' control is diluted.

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