7 T.C. 236 (1946)

A corporation that acquires substantially all the properties of a sole proprietorship in a tax-free exchange can compute its excess profits credit based on the income of the acquired proprietorship, even if the corporation itself was not in existence during the base period.

Summary

Faigle Tool & Die Corporation (petitioner) sought to compute its excess profits tax credit based on income, arguing it was an "acquiring corporation" under Section 740 of the Internal Revenue Code, having acquired substantially all the properties of a sole proprietorship, Faigle Tool & Die Co. The Tax Court held that the petitioner did acquire substantially all the properties of the proprietorship in a tax-free exchange, entitling it to compute its excess profits credit based on the income of the proprietorship during the relevant base period. The court rejected the Commissioner's argument that the petitioner failed to prove it acquired substantially all of the proprietorship's assets.

Facts

Karl Faigle operated Faigle Tool & Die Co. as a sole proprietorship, manufacturing machine tools, dies, and jigs. The proprietorship leased its machinery and equipment from an older corporation (also named Faigle Tool & Die Co., and wholly owned by Karl Faigle) and rented its plant. When the plant lease was terminated, Faigle purchased land and constructed a new plant. In February 1940, Faigle incorporated the petitioner, Faigle Tool & Die Corporation. The proprietorship then transferred its assets, including the new plant, the lease on the machinery, inventory, and cash, to the petitioner in exchange for stock and a demand note. The petitioner continued the same manufacturing business, using the same equipment and employees, with Faigle as president and general manager.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioner's income and excess profits tax liabilities for the fiscal year ended January 31, 1941. The petitioner contested the deficiency in excess profits tax, arguing it was entitled to compute its excess profits credit based on income, not just invested capital. The Tax Court considered whether the petitioner was an "acquiring corporation" under relevant sections of the Internal Revenue Code.

Issue(s)

Whether the petitioner, Faigle Tool & Die Corporation, acquired substantially all the properties of the Faigle Tool & Die Co. sole proprietorship in a tax-free exchange, thus qualifying as an "acquiring corporation" entitled to compute its excess profits credit based on income under Section 740 of the Internal Revenue Code.

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Holding

Yes, because the petitioner acquired substantially all the properties of the Faigle Tool & Die Co. sole proprietorship in a tax-free exchange, and is therefore entitled to compute its excess profits credit based on the income of the proprietorship.

Court's Reasoning

The Court reasoned that, under Section 740 of the Internal Revenue Code, a corporation acquiring "substantially all the properties" of a sole proprietorship in a tax-free exchange can use the income method to compute its excess profits credit. The Commissioner argued that the petitioner did not acquire substantially all of the proprietorship's assets. The Court disagreed, finding that the petitioner acquired all the machinery ever used by the proprietorship, the leasehold interest therein, the land, building, and machinery owned outright by the proprietorship, a significant amount of cash, accounts receivable, inventory, and prepaid insurance, and assumed almost $14,000 in liabilities. The Court emphasized the continuation of the same manufacturing business, using the same assets and personnel. The Court addressed the Commissioner's argument that the petitioner failed to account for certain assets listed on the proprietorship's books, explaining, "the record amply demonstrates that any of these amounts not shown to have been actually transferred to petitioner were used up in the operations of the proprietorship in the interval between the shut-down of active manufacturing and the organization of petitioner." The Court concluded that "within both the spirit and the letter of section 740 of the Internal Revenue Code, petitioner acquired substantially all of the properties of the Faigle Tool & Die Co., a sole proprietorship."

Practical Implications

This case provides guidance on determining whether a corporation qualifies as an "acquiring corporation" for the purpose of computing its excess profits credit. It emphasizes a practical, substance-over-form approach, focusing on the continuation of the same business with substantially the same assets, even if not every single asset is directly transferred. The decision highlights the importance of a thorough examination of the record to account for the disposition of assets and liabilities in determining whether "substantially all the properties" have been acquired. This case illustrates that the Tax Court will consider the realities of business operations when interpreting tax statutes, especially when there is a clear continuity of business operations before and after incorporation. It clarifies that the failure to transfer every single asset will not automatically disqualify a corporation from being considered an acquiring corporation if the overall transfer reflects a substantially complete acquisition of the business's assets and operations.

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