7 T.C. 600 (1946)

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When creditors of an insolvent corporation become the equitable owners of its assets through legal proceedings and subsequently receive voting stock in a newly formed corporation as part of a reorganization plan, the transaction qualifies as a nontaxable reorganization, allowing the new corporation to maintain the transferor's basis in the assets.

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Summary

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Peabody Hotel Company acquired the assets of an insolvent Memphis Hotel Company through a reorganization plan under Section 77-B of the Bankruptcy Act. The Tax Court addressed whether this transfer qualified as a nontaxable reorganization. The court held that the acquisition met the requirements of a nontaxable reorganization under Section 112(b)(4) and (g)(1)(B) of the 1934 Act because Peabody acquired substantially all of Memphis Hotel's properties solely for its voting stock, with the creditors of the insolvent company becoming the equitable owners. This entitled Peabody to the same basis in the assets as Memphis Hotel would have had.

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Facts

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Memphis Hotel Co. faced financial difficulties, leading to the appointment of receivers. Creditors, particularly bondholders, initiated proceedings asserting their liens. A reorganization plan was created and eventually approved by the court after Memphis Hotel filed for bankruptcy under Section 77-B. The plan involved transferring the Gayoso Hotel property to a new Gayoso Hotel Co., and the remaining assets, including the Peabody Hotel, to a newly formed Peabody Hotel Co. Peabody Hotel Co. issued stock to the Memphis Hotel Co.'s creditors and assumed certain liabilities.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies in Peabody Hotel Co.’s income and excess profits taxes. Peabody Hotel Co. petitioned the Tax Court for a redetermination, arguing that the Commissioner erred in disallowing depreciation and amortization deductions. The central dispute was the basis of the assets Peabody Hotel Co. acquired, with Peabody arguing for the transferor’s basis due to a nontaxable reorganization. The Tax Court considered the evidence and arguments presented by both parties.

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Issue(s)

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Whether the transfer of assets from Memphis Hotel Co. to Peabody Hotel Co. constituted a nontaxable reorganization under Section 112(b)(4) and (g)(1)(B) of the Revenue Act of 1934, as amended, thereby entitling Peabody Hotel Co. to use the transferor’s basis in those assets for depreciation and amortization deductions.

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Holding

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Yes, because Peabody Hotel Co. acquired substantially all of Memphis Hotel Co.’s properties solely for its voting stock as part of a reorganization plan, and the creditors of the insolvent Memphis Hotel Co. became the equitable owners, thus satisfying the continuity of interest requirement for a nontaxable reorganization.

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Court’s Reasoning

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The Tax Court reasoned that Peabody Hotel Co. acquired “substantially all the properties” of Memphis Hotel Co. within the meaning of Section 112(g)(1)(B), disregarding the transfer of the Gayoso Hotel property because the Gayoso bondholders had full priority rights to that property. The court found that the

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properties were acquired “solely for a part of its voting stock,” since the assumption of liabilities was disregarded under the statute. The court emphasized that the critical factor was that the creditors of the insolvent Memphis Hotel Co. became the equitable owners of the assets, satisfying the continuity of interest requirement: “pursuant to the plan and court orders, the Memphis Hotel Co.’s stockholders were eliminated as the equitable owners of the properties of that insolvent company and its creditors, to whom the stock in the Peabody Hotel Co. was issued, became such equitable owners instead, thus satisfying the required continuity of interest.” Because the requirements for a nontaxable reorganization were met, Peabody was entitled to the same basis in the assets as Memphis Hotel.

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Practical Implications

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This case illustrates the importance of establishing that creditors of an insolvent corporation have effectively become the equitable owners of the assets for a reorganization to be considered nontaxable. It highlights that the

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