10 T.C. 175 (1948)

When a corporation acquires property from its stockholders with an obligation to pay them from future sales proceeds, the corporation's basis in the property is its cost (the amount it agrees to pay), not a substituted basis from the transferors or a contribution to capital.

Summary

Hollywood, Inc. acquired property from its stockholders, Highway Construction Co. and Mercantile Investment & Holding Co., agreeing to pay them from the proceeds of future sales. The Tax Court addressed whether Hollywood, Inc.'s basis in the property was its cost, a substituted basis from the transferors, or a contribution to capital. The court held that the basis was Hollywood, Inc.'s cost, represented by its obligation to pay the transferors from sales proceeds. The court reasoned the transaction wasn't a tax-free exchange or a contribution to capital, but a purchase, establishing the corporation's cost basis.

Facts

Highway Construction Co. held judgments against properties in Hollywood, Florida. Mercantile Investment & Holding Co. held mortgages on the same properties. To resolve their conflicting interests, they formed Hollywood, Inc. Highway and Mercantile transferred properties to Hollywood, Inc., which agreed to liquidate the properties and pay Highway and Mercantile according to a schedule outlined in their agreement. Hollywood, Inc. sold some of these properties in 1939 and calculated its gain/loss using an "original valuation" of the lots. The Commissioner challenged this valuation, arguing it didn't represent the actual cost.

Procedural History

The Commissioner determined deficiencies in Hollywood, Inc.'s income and declared value excess profits taxes for 1939. Hollywood, Inc. petitioned the Tax Court, contesting the Commissioner's disallowance of its claimed basis in the properties sold. The Tax Court reviewed the case to determine the correct basis for calculating gain or loss on the sale of the properties.

Issue(s)

Whether Hollywood, Inc.'s basis in the properties acquired from Highway and Mercantile should be determined by: (1) the transferors' basis (substituted basis), (2) a contribution to capital, or (3) Hollywood, Inc.'s cost, represented by its obligation to pay the transferors from future sales proceeds.

Holding

No, because the properties were not transferred as a contribution to capital or in a tax-free exchange. Hollywood, Inc.'s basis is its cost, which is the amount it was obligated to pay to Highway and Mercantile from the proceeds of the sales.

Court's Reasoning

The Tax Court reasoned that the transaction was not a contribution to capital because the contemporaneous agreements showed a transfer for an agreed consideration. The court stated, "[T]he contemporaneous agreements show that the transaction was not a contribution to capital or paid-in surplus, but a transfer for an agreed consideration; and the mere adoption of bookkeeping notations not in accord with the facts and later corrected is insufficient to sustain any such position." The court also rejected the argument that the transfer qualified as a tax-free exchange under Section 112(b)(4) or 112(b)(5) of the Internal Revenue Code, as the properties were not transferred "solely" for stock or securities. The court emphasized that Hollywood, Inc.'s acceptance of the property under the contract imposed an obligation to perform, making its basis its cost, i.e., the amount it agreed to pay the transferors from the sale proceeds.

Practical Implications

This case clarifies the basis determination when a corporation acquires property with an obligation to pay the transferors from future proceeds. It confirms that such a transaction is treated as a purchase, establishing a cost basis for the corporation. Attorneys should analyze the agreements surrounding property transfers to determine if they constitute a sale rather than a tax-free exchange or contribution to capital. The case highlights the importance of aligning bookkeeping practices with the economic reality of the transaction. Later cases cite Hollywood, Inc. for the principle that a corporation's basis in acquired property is its cost when there's an obligation to pay for it, as opposed to a tax-free exchange or capital contribution scenario. The ruling provides a clear framework for tax planning in corporate acquisitions involving contingent payment obligations.

