11 T.C. 994 (1948)

A corporation cannot include the base period income of a partnership in its excess profits tax credit calculation when the partnership's assets were acquired after a restructuring that involved the withdrawal of a partner and a subsequent transfer through an intervening proprietorship or new partnership.

Summary

E. T. Renfro Drug Company sought to include the base period net income of several partnerships it acquired in its excess profits tax credit calculation. Prior to the acquisition, partners in the original partnerships withdrew, and the remaining partners briefly operated the businesses before transferring the assets to the corporation. The Tax Court held that the corporation could not include the income of the original partnerships because the assets passed through an intervening proprietorship or a new partnership, neither of which qualified as an "acquiring corporation" under the relevant tax code and regulations. Additionally, the court found that the corporation failed to acquire substantially all of the properties of one of the partnership groups.

Facts

E. T. Renfro Drug Company acquired the assets and businesses of several partnerships in 1939. Among these were the "Horn group" (Stores Nos. 2, 8, and 16) and the "Wren group" (Stores Nos. 1, 9, 15, and 20). Prior to the acquisition, Joe Horn and C.L. Wren were partners in their respective groups. Before Renfro Drug Company acquired the Horn group, Inez Renfro and Inez Renfro Allen bought out Horn's interest. Before acquiring the Wren group, Inez Renfro and Inez Allen bought out Wren's interest. Subsequently, Inez Renfro and Inez Allen transferred the assets of both the Horn and Wren groups to E. T. Renfro Drug Company in exchange for stock, owning more than 80% of the corporation's stock after the transfer.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in E. T. Renfro Drug Company's excess profits taxes for 1942 and 1943. The company petitioned the Tax Court for a redetermination, arguing it was entitled to include the base period net income of the partnerships in its excess profits credit calculation. The Tax Court ruled in favor of the Commissioner.

Issue(s)

1. Whether E. T. Renfro Drug Company was an "acquiring corporation" and the partnerships acquired were "component corporations" within the meaning of Section 740 of the Internal Revenue Code, allowing the company to include the partnerships' average base period net income in computing its excess profits credit.
2. Whether the base period net incomes of the partnerships were properly adjusted

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to reflect reasonable deductions for salaries or compensation of the partners.

Holding

1. No, because the partnerships' assets were acquired after the withdrawal of partners and a transfer through an intervening proprietorship or new partnership, which did not qualify as an "acquiring corporation" under the statute. Also, E.T. Renfro did not acquire substantially all of the Horn partnership assets.
2. The Court did not address the second issue because it ruled against the petitioner on the first issue.

Court's Reasoning

The Tax Court relied on Regulation 112, Section 35.740-4, which states that a partnership cannot be an acquiring corporation. The court reasoned that when Horn and Wren sold their interests, either a new partnership between Renfro and Allen was created, or Renfro and Allen acquired the assets as joint proprietors. In either case, the business experience of the original partnerships could not be transferred to the corporation because the intervening proprietors were not "acquiring corporations" as defined by the Internal Revenue Code. The court distinguished this case from *Ransohoffs Inc., 9 T.C. 376*, because that case involved a specific partnership agreement stating the partnership would continue despite a partner's withdrawal. Furthermore, the court noted that E. T. Renfro Drug Company did not acquire substantially all of the Horn partnership's properties, as Inez Renfro and Inez Allen retained accounts receivable and liquor/wine inventory.

Practical Implications

This case clarifies the requirements for a corporation to include the base period income of acquired partnerships in its excess profits tax credit calculation. It emphasizes the importance of maintaining the legal continuity of the partnership entity throughout the acquisition process. If partners withdraw and the remaining partners operate the business as a new partnership or individual proprietorship before the corporate acquisition, the corporation may lose the ability to utilize the original partnership's base period income for tax purposes. The decision highlights the significance of structuring partnership acquisitions to comply with specific requirements of the tax code and regulations, particularly regarding the definition of "acquiring corporation" and the acquisition of "substantially all" of the partnership's assets. It also underscores the binding effect of Treasury Regulations, especially where the regulation is reasonable and has been in existence for some time.

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