14 T.C. 786 (1950)

To qualify for a tax-free transfer of property to a corporation under Section 112(b)(5) of the Internal Revenue Code, the transferors must maintain control of the corporation immediately after the exchange; control is not established if the transferors are under a pre-existing obligation to transfer the stock to another party.

Summary

The executors of Samuel Klein's estate transferred his business assets to a newly formed corporation, S. Klein on the Square, Inc., receiving stock in return. Simultaneously, under a prearranged agreement, they transferred the stock to a third party. The corporation sought to use the estate's higher basis in the assets for depreciation deductions and to compute its excess profits credit based on the income of Klein's sole proprietorship. The Tax Court held that the transfer did not qualify for tax-free treatment under Section 112(b)(5) because the executors never maintained true control of the corporation, as they were obligated to transfer the stock immediately. Furthermore, the corporation could not claim the benefits of being a successor to Klein's sole proprietorship because the assets were acquired from the estate, a separate taxable entity, not directly from Klein.

Facts

- Samuel Klein operated a retail business as a sole proprietorship.
- Upon his death, his executors were directed to incorporate the business.
- The Surrogate's Court authorized the executors to sell the business, disregarding the will's incorporation directive.
- Herbert Daniel Stone, acting on behalf of Klein's family members, offered to purchase the business and transfer it to a corporation or to buy the stock of a corporation formed by the executors.
- The executors agreed to form a corporation (S. Klein on the Square, Inc.), transfer the business assets to it, receive stock, and then transfer the stock to Stone's group.
- The executors received stock and debentures but immediately endorsed the stock in blank for transfer to Stone's group.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the corporation's excess profits tax, disallowing the use of the estate's basis for depreciation and the computation of the excess profits credit based on Klein's sole proprietorship income. The corporation petitioned the Tax Court, contesting the Commissioner's determination.

Issue(s)

1. Whether the transfer of Samuel Klein's business assets to the corporation by

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his executors qualified for tax-free treatment under Section 112(b)(5) of the Internal Revenue Code, allowing the corporation to use the estate's basis for depreciation.
2. Whether the corporation was entitled to compute its excess profits credit based on the income of Samuel Klein's sole proprietorship business.

Holding

1. No, because the executors did not have the requisite control of the corporation immediately after the exchange, as they were obligated to transfer the stock to a third party under a prearranged agreement.
2. No, because the corporation acquired the assets from the estate of Samuel Klein, not directly from Samuel Klein as a sole proprietor; thus, it does not qualify as an acquiring corporation under sections 740, 741, and 742.

Court's Reasoning

The court reasoned that Section 112(b)(5) requires the transferors to be in control of the corporation "immediately after the exchange." Control, as defined in Section 112(h), means ownership of at least 80% of the voting stock and 80% of all other classes of stock. Here, the executors' ownership of the stock was merely a temporary step in an integrated plan to transfer the business to Stone's group. The executors were legally obligated to transfer the stock, negating any real control. The court cited *Wilbur F. Burns, 30 B.T.A. 163*, and *Hazeltine Corporation v. Commissioner, 89 F.2d 513*, emphasizing that control depends on the situation at the completion of the plan, not at an intermediate stage. Regarding the excess profits credit, the court held that the corporation acquired the assets from Klein's estate, not directly from Klein as a sole proprietor. Since the estate is a separate taxable entity, Klein was not a

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