14 T.C. 900 (1950)

Property received by a corporation as a capital contribution is included in equity invested capital at its unadjusted basis for gain or loss, which is the same as the transferor's basis, and failure to establish the transferor's basis is fatal to the claim.

Summary

Kay-Fries Chemical, Inc. challenged the Commissioner of Internal Revenue's decision to exclude $98,787.74 from its equity invested capital, representing the value of a secret formaldehyde manufacturing process received from its parent company, Tennants Consolidated, Ltd. The Tax Court upheld the Commissioner's determination, finding that Kay-Fries failed to provide evidence of Tennants' basis in the secret process. The court emphasized that under Sections 718(a)(2) and 113(a)(8) of the Internal Revenue Code, the basis of property contributed to capital is the same as the transferor's basis, and the taxpayer bears the burden of proving that basis.

Facts

Tennants Consolidated, Ltd., a UK-based formaldehyde manufacturer, owned all of Kay-Fries Chemical, Inc.'s stock through affiliates. In 1937, Tennants decided to manufacture formaldehyde in the U.S. through Kay-Fries, using its secret process. Tennants disclosed the process to Kay-Fries' chief chemist, who used it to construct manufacturing facilities. Kay-Fries began selling formaldehyde in 1938. Tennants provided the secret process to Kay-Fries at no capital cost or royalty, without a written contract. Kay-Fries did not issue stock or other consideration for the process and did not initially record the process as an asset on its books.

Procedural History

Kay-Fries claimed the value of the secret process ($98,787.74) as part of its equity invested capital on its 1941 and 1942 tax returns. The Commissioner of Internal Revenue disallowed this inclusion, leading to deficiencies in excess profits tax. Kay-Fries petitioned the Tax Court for a redetermination of the deficiencies.

Issue(s)

Whether the Commissioner erred in failing to include $98,787.74, representing the value of a secret process for manufacturing formaldehyde, in Kay-Fries' equity invested capital for excess profits tax purposes.

Holding

No, because Kay-Fries failed to prove the basis of the secret process in the hands of the transferor (Tennants), as required by Sections 718(a)(2) and 113(a)(8) of the Internal Revenue Code.

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Court’s Reasoning

The Tax Court relied on Section 718(a)(2) of the Internal Revenue Code, which states that property contributed to capital should be included in equity invested capital at its basis for determining loss upon sale or exchange. Further, Section 113(a)(8) specifies that the basis of property acquired by a corporation as a contribution to capital is the same as it would be in the hands of the transferor. The court noted that Kay-Fries presented no evidence of Tennants’ basis in the secret process. The Court emphasized that “[i]t was incumbent upon the petitioner to prove facts necessary to show that some amount should be included and to show the amount to be included.” The Court rejected Kay-Fries’ argument that the value of the process at the time of acquisition was relevant, stating that the relevant inquiry is the transferor’s basis. Since Kay-Fries failed to establish Tennants’ basis, the court concluded that the Commissioner’s determination was correct.

Practical Implications

This case highlights the importance of documenting the basis of assets contributed to a corporation, particularly intangible assets like secret processes or intellectual property. It establishes a clear precedent that the transferee corporation bears the burden of proving the transferor’s basis to include the asset in its equity invested capital for tax purposes. Legal practitioners must ensure that clients receiving capital contributions obtain and preserve records of the transferor’s basis to support valuation claims. The case also underscores that the value of the asset to the transferee is irrelevant; the focus remains on the transferor’s historical basis. Later cases cite Kay-Fries for the principle that a taxpayer must substantiate the basis of contributed property to include it in invested capital.

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