15 T.C. 35 (1950)

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To qualify as an acquiring corporation eligible for utilizing a predecessor's earnings history for excess profits tax credit purposes, a corporation must acquire substantially all of the predecessor's properties in a tax-free exchange where the transferors maintain proportionate control immediately after the exchange.

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Summary

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Hawaiian Freight Forwarders, Ltd. (petitioner) sought to utilize the earnings history of a predecessor partnership to calculate its excess profits tax credit. The Tax Court held that the petitioner was not an acquiring corporation under Section 740(a)(1)(D) of the Internal Revenue Code because the transfer of partnership assets to the corporation did not meet the requirements of Section 112(b)(5) for a tax-free exchange. Specifically, one partner was bought out prior to incorporation, and the remaining partners did not receive stock in proportion to their original partnership interests.

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Facts

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Hawaiian Freight Association, a partnership, was formed in 1937 by Leffel, Ballentyne, and Schnack. Leffel owned approximately 49%, Ballentyne 35%, and Schnack 15%. In 1940, Leffel and Ballentyne agreed to transfer the partnership's business to a newly formed corporation, Hawaiian Freight Forwarders, Ltd. Prior to incorporation, Schnack was bought out for $8,000, representing his interest in the partnership's assets and profits. The corporation issued 6,000 shares of stock, with 2,999 shares to Leffel, 2,998 to Ballentyne, and 3 to their nominees. The assets transferred included cash, receivables, furniture, and goodwill.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies in the petitioner's excess profits tax for the fiscal years ended November 30, 1943, and November 30, 1944. The petitioner challenged the Commissioner's determination, arguing that it was entitled to calculate its excess profits credit based on the income of its predecessor partnership. The Tax Court ruled in favor of the Commissioner.

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Issue(s)

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Whether the petitioner was an acquiring corporation of the partnership, Hawaiian Freight Association, within the meaning of Section 740(a)(1)(D) of the Internal Revenue Code.

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Holding

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No, because the transfer of partnership assets to the corporation did not meet the requirements of Section 112(b)(5) for a tax-free exchange, as one partner was bought out prior to incorporation and the remaining partners did not receive stock in proportion to their original partnership interests.

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Court's Reasoning

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The court focused on whether the acquisition of the partnership's assets qualified as a tax-free exchange under Section 112(b)(5) of the Internal Revenue Code. To qualify under this section, the exchange must be solely for stock or securities, and immediately after the exchange, the transferors must be in control of the corporation. Furthermore, when two or more persons are involved, the stock received by each must be substantially proportionate to their interest in the property prior to the exchange.

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The court found that Schnack's buyout prior to incorporation meant that substantially all of the partnership assets were not acquired in exchange for stock. Also, the distribution of stock to Leffel and Ballentyne was not proportionate to their prior interests in the partnership. Leffel held roughly 49% and Ballentyne 35%, but each received approximately 50% of the corporate stock. These failures to comply with Section 112(b)(5) disqualified the transaction from being a tax-free exchange, and thus, the petitioner could not be considered an acquiring corporation under Section 740(a)(1)(D). The court stated, "[T]he stock received by each such person must have been substantially in the same proportion as his interest in the property prior to the exchange."

