16 T.C. 75 (1951)

A corporate reorganization will not be invalidated for tax purposes under Section 129 of the Internal Revenue Code if the principal purpose of the reorganization is a legitimate business purpose, even if tax avoidance is a secondary consideration.

Summary

King Grocery Company, operating five wholesale grocery houses, reorganized into five separate corporations. The Commissioner argued the reorganization's primary purpose was tax avoidance under Section 129, seeking multiple excess profits tax exemptions. The Tax Court held that the principal purpose was a legitimate business purpose and not tax avoidance. The court emphasized business reasons such as increased borrowing capacity, limiting liability, handling competing merchandise lines, and mitigating local prejudice against absentee ownership. The petitioners were allowed the separate excess profits tax exemptions claimed by them.

Facts

Reeves Grocery Company, later King Grocery Company, operated a wholesale grocery business. By 1943, King operated five stores in different Mississippi towns. King's directors, anticipating a post-World War II depression and facing intense competition, considered reorganizing the company. They also noted that local banks could not loan King sufficient funds due to state law limitations, there was local resentment to outside chains, and the company could be liable for large tort judgments. On January 3, 1944, King reorganized into five separate corporations, each operating one of the former stores. The stockholders of King became the stockholders of the new corporations. Each corporation took the name of the county they were based in.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' excess profits tax. The petitioners challenged the Commissioner's determination, arguing they were entitled to separate excess profits tax exemptions. The Tax Court consolidated the cases for hearing.

Issue(s)

Whether the five petitioner corporations are entitled to a specific exemption from excess profits net income of $10,000 each under Section 710(b)(1) of the Internal Revenue Code, or only to a total exemption of $10,000 in each of the years 1944 and 1945, under Section 129 of the Code.

Holding

No, because the principal purpose of the reorganization was for legitimate business reasons, not primarily for tax evasion or avoidance.

Court’s Reasoning

The Tax Court found that the reorganization was primarily motivated by valid business reasons, including: increased borrowing capacity (Mississippi law limited bank loans to 15% of capital/surplus), limiting liability (tort judgments against one corporation wouldn’t affect others), enabling the handling of competing merchandise lines (exclusive franchises limited King’s product offerings), and eliminating prejudice against absentee ownership (local resentment toward the “King Grocery Company”). The court recognized the taxpayer’s right to minimize taxes but emphasized that Section 129 only applies when tax evasion is the “principal purpose.” The court cited *Gregory v. Helvering*, 293 U.S. 465, noting, “The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.” The court weighed the evidence and found the business reasons outweighed any tax avoidance motives.

Practical Implications

This case clarifies the application of Section 129, emphasizing that a corporate reorganization is not automatically invalidated simply because it results in tax benefits. The key is the “principal purpose” test. Businesses contemplating reorganizations must document and demonstrate legitimate business purposes beyond tax reduction. The presence of strong, non-tax reasons for the reorganization strengthens the argument against the application of Section 129. Later cases have cited Alcorn Wholesale when considering the primary motivation behind corporate restructurings, using it to illustrate when business purposes outweigh tax considerations.

