17 T.C. 171 (1951)

In a corporate reorganization where controlling interests remain the same, the basis of property transferred for stock, for the purpose of calculating equity invested capital, is the transferor's basis, not the fair market value at the time of transfer.

Summary

Prosperity Company reorganized, issuing new Class A and Class B stock in exchange for old stock, real estate, patents, and patent applications from family members and the National Chemical Company, along with cash from outside investors. The Tax Court addressed the issue of determining the equity invested capital, specifically focusing on the basis of the transferred property (patents, land, etc.) for stock. The court held that because the controlling interest (50% or more) remained within the same group after the reorganization, the unadjusted basis of the assets transferred to Prosperity Company was the same as it was in the hands of the transferors, not the fair market value at the time of the transfer.

Facts

Prior to 1926, Prosperity Company had common and preferred stock outstanding, largely held by the Braun family and National Chemical Company. National Chemical was primarily owned by S.J. Braun and his children. Prosperity Company manufactured laundry machinery. The company used certain patents from A.C. Austin, owned by G.A., A.R., P.N., and Mrs. S.J. Braun, under a royalty agreement. They also used patents from C.O. Reeps under a similar agreement. S.J. Braun owned land adjacent to Prosperity's facilities.

Procedural History

The Commissioner of Internal Revenue determined excess profits tax deficiencies for Prosperity Company for 1941 and 1942. Prosperity Co. challenged the deficiency, arguing for a higher equity invested capital based on the value of property paid in for stock during a 1926 reorganization. The Tax Court addressed the calculation of equity invested capital under Section 718(a)(2) of the Internal Revenue Code.

Issue(s)

1. Whether, in determining equity invested capital after a corporate reorganization, the basis of property (patents, land, etc.) transferred to the corporation in exchange for stock should be the fair market value of the stock at the time of the transfer.
2. Whether, immediately after the reorganization, an interest or control in the transferred property of 50% or more remained in the same persons.

Holding

1. No, because Section 113(a)(7) dictates that if the reorganization meets certain control requirements, the basis of the transferred property is the same as it would be in the hands of the transferor.
2. Yes, because the Braun family, National Chemical, Reeps, and Davis collectively retained a 50% interest in the property after the transfer of stock, patents and land to the corporation.

Court’s Reasoning

The court reasoned that the 1926 recapitalization qualified as a reorganization under the Internal Revenue Code. Because the Braun family and National Chemical Company retained at least 50% control of the company after the reorganization, Section 113(a)(7) applied. This section stipulates that the basis of the transferred assets for calculating equity invested capital is the same as it was in the hands of the transferors, not the fair market value at the time of the transfer to Prosperity Company. The court rejected Prosperity’s argument that the patents received from Reeps and Davis should be treated separately, finding that these transactions were integral to the reorganization plan. The court emphasized that “the transactions whereby the patents, applications for patents and rights were transferred to the petitioner, were a part of and were essential and prerequisite to the effecting of the reorganization.” Applying the rule from *Cohan v. Commissioner*, the court estimated the transferors’ bases in certain assets where exact figures were unavailable.

Practical Implications

This case clarifies the application of Section 113(a)(7) (now largely superseded but embodying similar principles in current reorganization provisions) in determining the basis of assets transferred during a corporate reorganization for purposes of calculating equity invested capital. It emphasizes that when a reorganization results in a continuation of control by the same parties, the tax basis of the assets does not get stepped up to fair market value. This decision has implications for tax planning related to corporate reorganizations, highlighting the need to carefully assess the control retained by transferors and to maintain accurate records of the transferors’ original basis in the assets. Later cases applying similar principles, particularly in the context of modern corporate tax law, often cite *Prosperity Co. v. Commissioner* as a foundational case in this area.

