17 T.C. 216 (1951)

The cost basis of stock received in a corporate liquidation is its fair market value at the time of transfer, unless the liquidation is part of a pre-existing plan of reorganization; absent such a plan, the liquidation is treated as an independent taxable event.

Summary

F.K. Ketler sought to establish a higher cost basis for shares received during a corporate liquidation, arguing it was part of a tax-free reorganization initiated years prior. The Tax Court disagreed, finding the liquidation was a separate event, not linked to the earlier reorganization efforts. Therefore, Ketler's basis in the shares was their fair market value when received during the liquidation, resulting in a taxable gain upon the subsequent liquidation of F.K. Ketler Co. This case clarifies that a liquidation is not automatically part of a reorganization plan and emphasizes the importance of demonstrating a clear, continuous plan for tax-free treatment.

Facts

In 1934, F.K. Ketler Co. #1 faced financial difficulties and was renamed Monroe Construction Co. (Monroe). Ketler formed a new corporation, F.K. Ketler Co. Monroe leased its assets to the new Ketler Co. and agreed to purchase Ketler Co.'s stock. Monroe later attempted a reorganization under the Bankruptcy Act but was unsuccessful. In 1941, Monroe liquidated, distributing its assets, including 252 shares of F.K. Ketler Co. stock, to Ketler who was its sole shareholder and a creditor. Ketler also assumed Monroe's remaining debts. In 1944, F.K. Ketler Co. liquidated, and Ketler claimed a loss, using a high basis for the 252 shares, arguing they were received as part of the 1934 reorganization.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Ketler's 1944 income tax, arguing that the 252 shares had a lower cost basis (fair market value at the time of Monroe's liquidation). Ketler contested this determination, arguing for a tax-free reorganization and a higher cost basis. The case was brought before the United States Tax Court.

Issue(s)

Whether the 1941 liquidation of Monroe Construction Company, where Ketler received 252 shares of F.K. Ketler Co. stock, was part of a pre-existing plan of reorganization such that Ketler's basis in those shares should reflect the original cost basis rather than the fair market value at the time of liquidation.

Holding

No, because the 1941 liquidation was not proven to be an integral part of a continuous reorganization plan that began in 1934; therefore, the cost basis of the 252 shares is their fair market value at the time they were transferred to Ketler in 1941.

Court's Reasoning

The court reasoned that while section 112 of the Internal Revenue Code provides exceptions for recognizing gains or losses during reorganizations, Ketler failed to prove the 1941 liquidation was part of a reorganization plan initiated in 1934. The court stated, "To support petitioner's position, the contested distribution must have been 'in pursuance of' the plan of reorganization finally executed." The court emphasized that in 1941, Monroe was insolvent, and Ketler received the shares as a creditor, not necessarily as part of a reorganization. Consequently, Ketler's basis was the fair market value of the shares at the time of receipt. The court cited H. G. Hill Stores, Inc., 44 B. T. A. 1182, noting that when an insolvent corporation transfers assets to a creditor, it is not necessarily a distribution in liquidation. The court found there was no evidence to justify finding the 1941 transaction was part of the original reorganization plan.

Practical Implications

This case highlights the importance of clearly documenting and demonstrating a continuous plan of reorganization to achieve tax-free treatment. Attorneys and tax advisors must advise clients to maintain records showing the intent and steps of a reorganization from its inception. The case serves as a caution that liquidations of insolvent companies are often treated as separate taxable events, especially when distributions are made to creditors. Later cases have cited Ketler for the principle that a distribution must be "in pursuance of" a reorganization plan to qualify for non-recognition of gain or loss. The case clarifies that merely attempting a reorganization is insufficient; a concrete, demonstrable plan is required to obtain the desired tax benefits.

