18 T.C. 96 (1952)

When a corporation acquires property in exchange for stock in a tax-free transaction, the corporation's basis in the property for calculating equity invested capital is the same as the transferor's basis, regardless of the property's fair market value at the time of transfer.

Summary

Evan Jones Coal Company argued that it was entitled to a larger excess profits tax credit based on invested capital, claiming its equity invested capital should include $128,800 for a lease acquired in exchange for stock. The Tax Court ruled that because the transfer of the lease for stock was a tax-free exchange under Section 112(b)(5) and its predecessor, the corporation's basis in the lease was the same as the transferor's basis. The court also found the lease's fair market value at the time of transfer was far less than the claimed $128,800, thus the company's excess profits credit would not be impacted.

Facts

Evan Jones applied for a coal land lease before July 24, 1920. Jones and four associates agreed on July 24, 1920, to form a corporation (Evan Jones Coal Company) to which Jones would transfer the lease. The corporation was incorporated in Alaska on January 19, 1921. At a February 9, 1921 board meeting, Jones proposed transferring the lease to the corporation for $128,800 in stock, which the directors approved. 130,000 shares were issued to Jones and then redistributed equally to the five associates. The fair market value of the lease at the time of acquisition was less than $20,000.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Evan Jones Coal Company's excess profits tax for fiscal years ended July 31, 1943, and July 31, 1944. The company contested this assessment, arguing it was entitled to a larger excess profits tax credit based on invested capital. The Tax Court ruled in favor of the Commissioner.

Issue(s)

Whether the basis of the lease acquired by Evan Jones Coal Company in exchange for stock should be the fair market value of the lease at the time of acquisition ($128,800), or the transferor's basis in the lease, for purposes of calculating equity invested capital and the excess profits tax credit.

Holding

No, because the transfer of the lease for stock was a tax-free exchange, the

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corporation’s basis in the lease is the same as the transferor’s basis, not the fair market value at the time of the exchange.

Court’s Reasoning

The court relied on Section 718(a)(2) of the tax code, which states that property paid in for stock should be included in equity invested capital at its basis for determining loss upon sale or exchange. Section 113(a)(8) dictates that if property is acquired after December 31, 1920, by a corporation issuing stock in a transaction described in Section 112(b)(5), the basis is the same as it would be in the hands of the transferor. Section 112(b)(5) specifies that no gain or loss is recognized when property is transferred to a corporation in exchange for stock, and the transferors are in control of the corporation immediately after the exchange. Because the transfer met these conditions, the court concluded that the corporation’s basis in the lease was the transferor’s basis. The court stated, “Obviously the acquisition was not completed within the meaning of section 113 (a) (8) (A) until the issuance of the stock which necessarily took place after December 31, 1920, since there was no corporation and there was no stock until after that date.” Furthermore, the court found that even if the acquisition occurred before December 31, 1920, the petitioner failed to prove that the lease had a value of $128,800.

Practical Implications

This case illustrates the importance of determining the transferor’s basis in property contributed to a corporation in exchange for stock, particularly when calculating equity invested capital for tax purposes. It emphasizes that tax-free exchanges under Section 351 (formerly Section 112(b)(5)) result in a carryover basis, preventing corporations from inflating their asset bases and, consequently, their tax credits, merely by issuing stock. Attorneys should carefully analyze the tax implications of such transactions, focusing on the transferor’s original basis and the applicability of Section 351. This principle continues to apply to modern tax law under Section 362 regarding basis to corporations for property acquired as contributions to capital.

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