***19 T.C. 305 (1952)***

A company's basis for goodwill, for equity invested capital purposes, is determined by its cost, which is the fair market value of the stock issued in exchange for that goodwill; furthermore, the amortization period for leasehold improvements includes renewal periods if renewal is reasonably certain.

## Summary

Hens & Kelly, Inc. sought to include $400,000 for goodwill in its equity invested capital and to amortize leasehold improvements over the initial lease term, excluding renewal periods. The Tax Court determined that the goodwill's value was only $100,000, based on the fair market value of the stock issued for it. The court also ruled that the amortization period for leasehold improvements must include the renewal periods because, at the time, it was reasonably certain that the company would exercise its option to renew the lease, as evidenced by the company's prior actions and filings.

## Facts

Hens & Kelly, Inc. was formed in 1940 from the consolidation of Hens & Kelly Company and S H Company, Inc. Hens & Kelly Company had acquired its business, including goodwill, in 1909 from The Hens-Kelly Company in exchange for stock. In 1922, Hens & Kelly Company entered into leases with options to renew until 1982 and made significant leasehold improvements. Prior to the consolidation, new leases were negotiated. Hens & Kelly Company filed Form 969 to elect to continue amortizing leasehold improvements over the original and renewal periods. Hens & Kelly, Inc. sought to include a $400,000 valuation of goodwill and amortize leasehold improvements only over the base lease term.

## Procedural History

Hens & Kelly, Inc. petitioned the Tax Court, contesting deficiencies in excess profits taxes for the fiscal years ended January 31, 1943, and January 31, 1944. The primary disputes centered on the valuation of goodwill for equity invested capital and the appropriate period for amortizing leasehold improvements.

## Issue(s)

1. Whether petitioner is entitled, in determining equity invested capital, to include $400,000 representing goodwill.
2. Whether petitioner is entitled to amortize the unrecovered cost of leasehold improvements under the terms of the 1940 lease for the lease term alone, without regard to the renewal period.

## Holding

 

1. No, because the fair market value of the goodwill acquired by Hens & Kelly Company was $100,000, based on the value of the stock issued in exchange.
2. No, because it was reasonably certain during the taxable years that the petitioner would exercise its option to renew the lease, thus the amortization period must include the renewal period.

## Court's Reasoning

Regarding goodwill, the court stated that under Section 718(a)(2) of the Internal Revenue Code, property paid in for stock is included in equity invested capital at its basis for determining loss upon sale or exchange. Since the goodwill was acquired before March 1, 1913, its basis was its cost. The Court determined that the cost of property acquired through the issuance of stock is the fair market value of the stock on the date issued. While petitioner claimed the goodwill was worth $400,000, the court found the company's financial condition prior to the acquisition questionable and that the book value entry lacked supporting documentation. The court looked to evidence suggesting the fair market value of the stock issued, and determined the goodwill to be $100,000.

Regarding leasehold improvements, the court applied Section 29.23(a)-10 of Regulations 111, stating that amortization should be spread over the lease term plus renewal periods if renewal is reasonably certain. The court found that the petitioner's actions, including filing Form 969 and consistently amortizing over the extended period, demonstrated a reasonable certainty of renewal. The court distinguished Bonwit Teller & Co. v. Commissioner, noting that the applicable regulation at the time did not permit amortization over renewal periods.

The court stated, "It is manifest, of course, that the statement appearing in Mertens is merely that of a digester's views as to what certain decided cases hold. It may not properly be regarded as controlling authority for the decision of this or any other case…"

## Practical Implications

This case clarifies the method for determining the value of goodwill for equity invested capital purposes, linking it to the fair market value of consideration (stock) exchanged for it. It also demonstrates that a company's actions and representations regarding lease renewals can be used to determine whether renewal is "reasonably certain," impacting the amortization period for leasehold improvements. This case highlights the importance of contemporaneous documentation and consistent accounting practices. Furthermore, this decision illustrates that courts prioritize regulatory text over secondary sources like treatises when interpreting tax law. Later cases applying this ruling would examine the specific facts and circumstances to ascertain whether a reasonable certainty of renewal exists, especially in light of changing market conditions.