Hens & Kelly, Inc. v. Commissioner, 19 T.C. 305 (1952)

The cost of goodwill acquired by a corporation through the issuance of its stock is the fair market value of the stock at the time it was issued, and if the stock's value is not readily ascertainable, the fair market value of the assets received can be considered to determine the stock's value.

Summary

Hens & Kelly, Inc. disputed the Commissioner's determination of deficiencies in excess profits taxes for the years 1941-1944. The central issues involved the valuation of goodwill acquired during a corporate consolidation and the amortization of leasehold improvements. The Tax Court determined the value of the goodwill based on the circumstances at the time of acquisition and held that the leasehold improvements should be amortized over the original lease term plus renewal periods because renewal was reasonably certain. The court emphasized the taxpayer's consistent treatment of the lease as renewable.

Facts

In 1909, Hens & Kelly Company acquired the assets and business of The Hens-Kelly Company. Hens & Kelly Company issued 4,000 shares of its common stock, allegedly for the goodwill of The Hens-Kelly Company. In 1940, Hens & Kelly Company consolidated with S H Company, Inc., to form Hens & Kelly, Inc. The new entity continued to operate the department store. Leases for the store premises, originally negotiated in 1922, included options to renew until 1982, with rental rates for the renewal periods based on property appraisals at the time of renewal. The taxpayer consistently amortized leasehold improvements over the entire period, including renewal options.

Procedural History

The Commissioner assessed deficiencies in the petitioner's excess profits tax for the taxable years, arguing that the goodwill was overvalued and that the leasehold improvements should not be amortized over the renewal periods. The Tax Court reviewed the Commissioner's determination.

Issue(s)

1. Whether the petitioner correctly valued the goodwill acquired from its predecessor, The Hens-Kelly Company, for equity invested capital purposes.
2. Whether the petitioner is entitled to amortize the unrecovered cost of leasehold improvements over the original lease term, without regard to its option to extend the lease.

Holding

© 2025 SCOTUSreports.com. All rights reserved.

1. No, because the petitioner failed to prove that the goodwill had a fair market value of $400,000 at the time of acquisition; the court determined the value to be $100,000.
2. No, because the facts showed a reasonable certainty that the lease would be renewed, justifying amortization over the original and renewal periods.

Court's Reasoning

Regarding goodwill, the court noted that while the directors of Hens & Kelly Company initially valued the acquired business at the consideration paid, including $400,000 for goodwill, this valuation was based on figures from the predecessor's books, with no clear basis. The court emphasized that the credit of The Hens-Kelly Company was poor prior to the acquisition and that operational changes were needed. The court found that the petitioner had not established a fair market value of $400,000 for the goodwill at the time of acquisition. The court determined that the cost of the goodwill was $100,000, considering all the evidence presented.

Regarding the leasehold improvements, the court relied on Treasury Regulation 111, Section 29.28(a)-10, which states that amortization over the renewal period depends on the facts of the case. The general rule is that absent renewal or reasonable certainty of renewal, costs should be spread over the original lease term. The court emphasized that the petitioner had consistently amortized the improvements over the entire period, including renewals, and had even filed a formal election to do so. The court found that the petitioner's actions demonstrated a "reasonable certainty" of renewal, outweighing arguments based on potential changes in rental rates or business conditions.

The court noted that the taxpayer's reliance on cases like Bonwit Teller was misplaced because the regulations in those cases did not have provisions to permit amortization of the leasehold improvements with the renewal period. The court stated that the petitioner seemingly accepted the regulation and only argued that there was no reasonable certainty that the lease would be renewed.

Practical Implications

This case underscores the importance of contemporaneous valuation of goodwill and other intangible assets in corporate transactions. It highlights that book values alone are insufficient to establish fair market value for tax purposes. The case also provides guidance on amortizing leasehold improvements, emphasizing that a taxpayer's consistent treatment of a lease as renewable can be strong evidence of a "reasonable certainty" of renewal, even if the renewal terms are not fixed. This decision clarifies that the regulations in place at the time the lease was made are important for determining whether a renewal can be included in the life of the lease.

© 2025 SCOTUSreports.com. All rights reserved.