20 T.C. 857 (1953)

To qualify as an ‘acquiring corporation’ for excess profits tax credit based on a predecessor partnership’s income, a corporation must acquire ‘substantially all’ of the partnership’s properties in a tax-free exchange under Section 112(b)(5) of the Internal Revenue Code, with ‘substantially all’ interpreted practically based on the nature and purpose of retained assets.

Summary

R. & J. Furniture Company, a corporation, sought excess profits tax credits based on the income history of its predecessor partnership. The Tax Court addressed whether the corporation qualified as an ‘acquiring corporation’ under Section 740(a)(1)(D) of the Internal Revenue Code, which required acquiring ‘substantially all’ of the partnership’s properties in a Section 112(b)(5) exchange. The court held that the corporation did meet this requirement, even though the partnership retained the fee simple of the real estate, because the corporation received a long-term leasehold interest, considered ‘substantially all’ in this context, along with other essential business assets like goodwill and receivables. The court further addressed adjustments to the partnership’s base period net income for calculating the excess profits credit, disallowing certain deductions.

Facts

The R. & J. Furniture Company partnership, established in 1932, conducted a retail furniture business. In 1940, the partnership incorporated as The R. & J. Furniture Company (petitioner). On June 1, 1940, the partnership transferred most of its assets to the corporation in exchange for stock and the assumption of liabilities. The transferred assets included stock in trade, fixtures, equipment, goodwill, leasehold estates (though not explicitly a lease from themselves yet), and accounts receivable. Critically, the partnership retained the fee simple ownership of the real estate where the business operated, but simultaneously leased this real estate to the newly formed corporation for a 55-year term, with the corporation obligated to pay rent and property expenses. The partnership dissolved immediately after this transfer and ceased business operations. The corporation continued the same furniture business at the same location. The IRS challenged the corporation’s claim to be an ‘acquiring corporation’ for excess profits tax purposes, arguing it did not acquire ‘substantially all’ of the partnership’s properties because the real estate fee remained with the partners.

Procedural History

The R. & J. Furniture Company, the corporation, petitioned the Tax Court of the United States regarding deficiencies in income and excess profits taxes for the years 1942-1945. The primary issue was whether the corporation qualified as an ‘acquiring corporation’ under Section 740(a)(1)(D) of the Internal Revenue Code,

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which would allow it to compute excess profits credit based on the partnership's historical income. The Commissioner of Internal Revenue contested this status.

Issue(s)

1. Whether the petitioner, The R. & J. Furniture Company corporation, acquired 'substantially all' of the properties of The R. & J. Furniture Company partnership in an exchange to which Section 112(b)(5) of the Internal Revenue Code applies, thereby qualifying as an 'acquiring corporation' under Section 740(a)(1)(D).
2. Whether certain adjustments to the partnership's base period net income, specifically regarding officers' salaries, bad debt deductions, and unemployment insurance taxes, were properly determined for the purpose of computing the petitioner's excess profits tax credit.

Holding

1. Yes, the petitioner acquired 'substantially all' of the partnership's properties because, in the context of the ongoing business and the long-term leasehold interest transferred, retaining the fee simple of the real estate by the partners did not negate the 'substantially all' requirement, especially considering the transfer of essential operating assets and goodwill.
2. No, regarding officers' salaries, the court sustained the Commissioner's determination due to the petitioner's failure to prove the reasonableness of lower salary deductions. Yes, in part, regarding bad debt deductions, the court held that an abnormal bad debt deduction from 1937 should be partially disallowed. No, regarding unemployment insurance taxes, the court disallowed adjustments as the petitioner failed to prove that the abnormality was not due to changes in business operations.

Court's Reasoning

The Tax Court reasoned that the term 'substantially all' is relative and fact-dependent, citing *Daily Telegram Co., 34 B.T.A. 101*. The court emphasized that the key factors are the nature, purpose, and amount of properties retained by the partnership. Although the partnership retained the real estate fee, it transferred a 55-year lease to the corporation. The court noted that Treasury Regulations classified such long-term leaseholds as 'like kind' property to a fee simple for tax purposes, citing *Century Electric Co., 15 T.C. 581*. Thus, the corporation effectively acquired the operational control and long-term use of the real estate, which was crucial for the furniture business. The court stated, '*Thus, it appears that petitioner acquired a leasehold interest in the property, the bare fee of which was retained, and, which, if not the equivalent of a fee, constituted substantially all of the partnership's interest therein.*' The court also considered the transfer of goodwill and other business assets, concluding that '*petitioner acquired substantially all of the partnership's properties in 1940 solely in exchange for stock.*'

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Regarding adjustments to base period income, the court addressed officers' salaries, bad debts, and unemployment taxes. For salaries, the court found the petitioner failed to prove that the salaries initially claimed by the petitioner itself were unreasonable. For bad debts, the court found an abnormal deduction in 1937 due to a change in accounting method and partially disallowed it as an adjustment. For unemployment taxes, the court found insufficient evidence to prove that fluctuations were not related to business changes, thus disallowing adjustments.

Practical Implications

R. & J. Furniture Co. provides guidance on the 'substantially all properties' requirement in tax-free incorporations under Section 351 (formerly Section 112(b)(5)) and for accessing predecessor business history for tax benefits like excess profits credits (relevant under prior law, but the principle of business continuity remains). It clarifies that 'substantially all' does not necessitate a literal transfer of every single asset, especially when the retained assets (like the real estate fee here) are effectively made available to the corporation through long-term leases or similar arrangements. This case is important for structuring corporate formations from partnerships or sole proprietorships, indicating that retaining real estate ownership outside the corporation while granting long-term leases to the operating entity may still satisfy the 'substantially all' requirement for certain tax benefits. It highlights a practical, business-oriented interpretation of 'substantially all,' focusing on the operational assets essential for the business's continuation rather than a strict numerical percentage of all assets. Later cases and rulings continue to interpret 'substantially all' in light of the operational needs of the business being transferred, considering the nature of the assets and the business context.

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