23 T.C. 923 (1955)

A transfer of property and cash to a corporation in exchange for stock can constitute a nontaxable exchange under IRC Section 112(b)(5) if the transferors control the corporation immediately after the exchange, and the stock received is substantially proportionate to the value of the property or cash transferred.

Summary

The United States Tax Court addressed whether a transaction involving the transfer of real property and cash to a newly formed corporation in exchange for stock qualified as a nontaxable exchange under Section 112(b)(5) of the Internal Revenue Code of 1939. The court held that the exchange was nontaxable, as the transferors of both property and cash received stock, and, immediately after the exchange, they controlled the corporation, with the stock received being proportionate to their contributions. The court relied on the precedent established in *Halliburton v. Commissioner*, which held that property under the statute includes cash and that the simultaneous contribution of both property and cash to a corporation in exchange for stock can qualify as a nontaxable exchange.

Facts

A corporation, La Habra Orange Mesa, was formed on February 2, 1949. On March 10, 1949, it issued preferred and common stock to two individuals, Langdon and Keelan, in exchange for real property. On the same day, the corporation issued common stock to Burrell and Holstein for cash. No other shares were ever issued. The corporation used a cost basis of $16,710 for the real property when calculating gain or loss on the sale of the property. The Commissioner of Internal Revenue determined that the property's basis in the corporation's hands was the same as it was in the hands of Langdon and Keelan, which was significantly lower. The primary issue was whether this constituted a non-taxable exchange under Section 112(b)(5).

Procedural History

The Commissioner of Internal Revenue determined income tax deficiencies against La Habra Orange Mesa. The petitioners, as transferees of the corporation, did not contest their liability for the deficiencies but challenged the calculation of the corporation's tax liability. The case was heard by the United States Tax Court, which issued a ruling based on a stipulated set of facts.

Issue(s)

1. Whether the transfer of real property and cash to La Habra Orange Mesa in exchange for stock qualified as a nontaxable exchange under Section 112(b)(5) of the Internal Revenue Code of 1939.

Holding

1. Yes, because the transaction met all requirements of Section 112(b)(5).

Court's Reasoning

The court applied Section 112(b)(5), which states that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock, and immediately after the exchange, such person or persons are in control of the corporation. The court found that the term "property" includes cash, following the precedent of *Halliburton v. Commissioner*. The court distinguished the case from *Lanova Corporation*, where the proportional interests of the transferors were disturbed because of the receipt of cash. The court held that the transferors, including those who contributed cash, received all the stock and obtained complete control of the corporation immediately after the exchange. Additionally, the court noted the statute requires that the stock received be substantially in proportion to the transferor's interest in the transferred property. The court emphasized that the control requirement did not mean the transferors' interests had to be proportionate to each other, but rather that the amount of stock received by each was proportionate to the value of the transferred property or cash.

Practical Implications

This case is a fundamental illustration of the practical application of Section 112(b)(5) (now Section 351 of the Internal Revenue Code of 1986) regarding non-recognition of gain or loss on transfers to a controlled corporation. It confirms that property under the statute can include cash, and that the transaction remains tax-free even if some transferors contribute property and others contribute cash, as long as the transferors, in the aggregate, control the corporation. This case clarifies how the stock distribution should be allocated. Lawyers and accountants should consider this case when structuring the formation of corporations to take advantage of the tax-free exchange provisions. Failure to meet these requirements would result in the recognition of gain or loss on the transfer of assets to the corporation, which could significantly impact the tax liability of the transferors. The *Halliburton* line of cases is key precedent. Additionally, the court's focus on the proportionate value of the contribution is an important point of analysis for practitioners.