24 T.C. 350 (1955)

A corporate reorganization qualifies for non-recognition of gain under Internal Revenue Code § 112(b)(3) and § 112(g)(1)(D) if it has a valid business purpose, continuity of interest, and follows a plan of reorganization, even if it is designed to facilitate a subsequent sale of stock.

Summary

In *Farr v. Commissioner*, the U.S. Tax Court addressed whether a corporate reorganization, involving the transfer of real estate assets to a new corporation and the subsequent exchange of stock, was tax-free under the Internal Revenue Code. The court found that the reorganization had a valid business purpose and continuity of interest, despite the ultimate goal of facilitating a later sale of the taxpayer's stock. This case established that a reorganization can be tax-free even when it serves multiple purposes, including preparing for a future stock sale, so long as a clear business need is addressed and the statutory requirements are met.

Facts

Rena Farr inherited a sole proprietorship, Farr Motor Sales, from her husband. The business sold Studebaker automobiles. Studebaker required Farr to obtain better facilities for the business. Farr purchased two lots, intending to build on one. Farr organized Farr Motor Sales, Inc. (Motor Sales). Farr transferred the proprietorship assets, including the lot, to Motor Sales in exchange for all 250 shares of its stock. Later, Motor Sales transferred the lots and a building to a new corporation, Farr Realty Corporation (Realty), for all of Realty's stock. Farr then exchanged 50 shares of Motor Sales stock for all the shares of Realty. The Commissioner argued that this was a taxable dividend.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Farr's income tax for 1949, asserting that the exchange of stock was a taxable dividend. The case was brought before the United States Tax Court. The Tax Court reviewed the facts and legal arguments to determine the taxability of the stock exchange, ultimately ruling in favor of the taxpayer.

Issue(s)

1. Whether the real estate and improvements at issue were assets of Farr Motor Sales immediately prior to the reorganization?

2. Whether the transfer of assets from Motor Sales to Realty was a statutory reorganization under I.R.C. § 112(g)(1)(D)?

3. Whether the exchange of stock between Farr and Motor Sales was a tax-free

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exchange under I.R.C. § 112(b)(3) as part of a plan of reorganization?

Holding

1. Yes, because, despite legal title being in Farr's name, the evidence showed that Motor Sales owned the assets.

2. Yes, because the transfer of the property from Motor Sales to Realty met the statutory definition of a reorganization under § 112(g)(1)(D).

3. Yes, because the stock exchange was part of a plan of reorganization, thus, the exchange qualified as tax-free under § 112(b)(3).

Court's Reasoning

The court first addressed the ownership of the property, determining that Motor Sales owned the real estate, even when title was in Farr's name. The court emphasized that Farr was acting as a trustee for Motor Sales. Next, the court considered whether the reorganization met the requirements of I.R.C. § 112(g)(1)(D). The court found that the transfer of assets from Motor Sales to Realty, followed by the shareholders of Motor Sales having control of the new corporation (Realty), met the definition of a reorganization. The court noted, "A reorganization is defined in section 112 (g) (1) (D) as 'a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred * * *" Lastly, the court addressed whether the stock exchange was tax-free under § 112(b)(3). The court found that all exchanges were made in pursuance of the plan of reorganization. The court cited *Chester E. Spangler*, 18 T.C. 976, which considered this reorganization and found, "that the exchange falls within the terms of section 112 (b) (4) if there are no other requirements." The court found that the exchange was a tax-free exchange.

Practical Implications

This case is essential for understanding the requirements for tax-free corporate reorganizations. It underscores the importance of having a valid business purpose beyond merely tax avoidance and maintaining continuity of interest. In practice, attorneys should consider this case when advising clients on corporate restructuring, specifically when contemplating a split-off. The ruling clarifies that a plan of reorganization can be viewed as a single, integrated transaction, affecting how courts analyze the steps involved. The ruling provides certainty and a framework for structuring such transactions, particularly in the context of businesses seeking to separate assets or prepare for a sale.

Meta Description

The case of *Farr v. Commissioner* provides guidance on the tax treatment of

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corporate reorganizations, particularly involving the transfer of assets, in which the court found the exchanges to be tax-free.

Tags

Farr v. Commissioner, Tax Court, 1955, Corporate Reorganization, Continuity of Interest, Business Purpose, Tax-Free Exchange

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