29 T.C. 433 (1957)

For a merger to qualify as a tax-free reorganization, there must be a continuity of interest, meaning the shareholders of the merged corporation must maintain a proprietary interest in the surviving corporation.

Summary

The case involved the tax consequences of a merger between Pocahontas Tanning Company and Howes Leather Company, Inc. The key issue was whether the transaction qualified as a tax-free reorganization under the Internal Revenue Code. The court held that it was not. The former shareholders of Pocahontas received short-term notes and long-term bonds, which the court determined did not represent a continuing proprietary interest in the surviving corporation. Consequently, the exchange was treated as a sale, and the shareholders were subject to capital gains tax rather than reorganization treatment. This case highlights the importance of the "continuity of interest" doctrine in determining whether a transaction qualifies for non-recognition of gain or loss in corporate reorganizations.

Facts

Pocahontas Tanning Company (Pocahontas), a West Virginia corporation, was engaged in manufacturing and selling sole leather. Howes Leather Company, Inc. (Leather Company), a Delaware corporation, was formed to merge with Howes Brothers Company and other affiliated corporations. Pocahontas shareholders were offered the opportunity to sell their stock to the Leather Company. The stockholders of Pocahontas agreed to sell their stock to the Leather Company, and Pocahontas formally merged into the Leather Company. In exchange for their stock, the Pocahontas shareholders received short-term notes, and 20-year first mortgage bonds from the Leather Company. The IRS determined that the exchange constituted a tax-free reorganization and that part of the value of the notes was taxable as a dividend. The shareholders contended the transaction was a sale resulting in a capital gain.

Procedural History

The case was heard in the United States Tax Court. The Commissioner of Internal Revenue determined tax deficiencies, arguing that the transaction qualified as a tax-free reorganization, resulting in dividend income. The taxpayers challenged this determination, asserting that the exchange was a sale of stock, thus generating capital gains. The Tax Court ruled in favor of the taxpayers, finding that the exchange was a sale rather than a reorganization.

Issue(s)

1. Whether the merger of Pocahontas into the Leather Company constituted a

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