H. B. Zachry Co. v. Commissioner, 49 T. C. 73 (1967)

A carved-out oil payment constitutes 'property' under section 351 of the Internal Revenue Code, allowing for a tax-free exchange when transferred to a controlled corporation in exchange for stock.

Summary

H. B. Zachry Co. transferred a carved-out oil payment to its subsidiary, Zachry Minerals, Inc. , in exchange for all of the subsidiary's common stock. The subsidiary then purchased preferred stock from H. B. Zachry Co. with borrowed funds. The IRS argued that these transactions should be treated as a single taxable event. The Tax Court held that the oil payment was 'property' under section 351, and the transactions were separate, resulting in no taxable gain to H. B. Zachry Co. This decision clarified that oil payments could be considered property for nonrecognition purposes under section 351, impacting how similar corporate reorganizations and asset transfers are treated for tax purposes.

Facts

H. B. Zachry Co. (the petitioner) merged with Gasoline Production Corp. , acquiring oil and gas properties and a $750,000 note due in January 1962. To improve its bidding capacity, the petitioner formed Zachry Minerals, Inc. (Minerals) and transferred a carved-out oil payment worth $650,000 to Minerals in exchange for all of Minerals' common stock. Subsequently, Minerals borrowed $650,000 from a bank, using the oil payment as collateral and the personal endorsement of H. B. Zachry. Minerals then purchased 6,328 shares of the petitioner's preferred stock for $649,000, which the petitioner used to retire the $750,000 note.

Procedural History

The IRS determined a tax deficiency against H. B. Zachry Co. for 1961, arguing that the transactions with Minerals resulted in taxable income of $649,000. H. B. Zachry Co. appealed to the Tax Court, which held in favor of the petitioner, ruling that the transfer of the oil payment qualified for nonrecognition under section 351 and the sale of preferred stock was a nontaxable exchange under section 1032.

Issue(s)

1. Whether a carved-out oil payment constitutes 'property' within the meaning of section 351(a) of the Internal Revenue Code?
2. Whether the transfer of the oil payment to Minerals and the subsequent sale of preferred stock to Minerals should be treated as a single integrated transaction?

Holding

1. Yes, because a carved-out oil payment is an interest in land with present value,

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qualifying as ‘property’ under section 351.
2. No, because the two transactions were separate and had independent economic substance and business purpose, thus not constituting a single integrated transaction.

Court’s Reasoning

The court determined that a carved-out oil payment is ‘property’ under section 351, citing cases that recognized oil payments as interests in land. The court rejected the IRS’s argument that the oil payment was merely a ‘pure income right,’ emphasizing its present value and interest in land. Regarding the transactions, the court found that the transfer of the oil payment for stock and the sale of preferred stock for cash were separate transactions, each with economic reality and business purpose. The court applied criteria such as the intent of the parties, the mutual interdependence of steps, the time element, and the ultimate result to conclude that the transactions were not substantively interdependent. The court also noted that the IRS’s alternative taxable course of action was not compelling given the petitioner’s legitimate use of nontaxable sections 351 and 1032.

Practical Implications

This decision has significant implications for corporate reorganizations and asset transfers involving oil and gas interests. It confirms that carved-out oil payments can be treated as ‘property’ for tax-free exchanges under section 351, providing a clear guideline for structuring similar transactions. The ruling also underscores the importance of demonstrating economic substance and business purpose in each step of a transaction to avoid tax recharacterization. Legal practitioners should consider this when advising clients on corporate restructuring involving natural resource assets. Subsequent cases have cited H. B. Zachry Co. in analyzing the tax treatment of oil and gas asset transfers, reinforcing its role in shaping tax law in this area.

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