R. M. Smith, Inc. v. Commissioner, 69 T. C. 317 (1977)

In a corporate liquidation under Section 334(b)(2), the parent's adjusted basis in the subsidiary's stock must be refined and then allocated among the acquired assets based on their fair market values.

Summary

R. M. Smith, Inc. acquired and liquidated Gilmour Co. , leading to a dispute over how to calculate and allocate the adjusted basis of the assets received. The key issue was the interpretation of Section 334(b)(2) and related regulations, specifically how to refine the adjusted basis of the stock and allocate it among the tangible and intangible assets. The court clarified that the adjusted basis should be adjusted for liabilities assumed, interim earnings and profits, and cash received, then allocated proportionally to the fair market values of the assets, with specific exceptions for cash equivalents and accounts receivable.

Facts

R. M. Smith, Inc. purchased all the stock of Gilmour Co. on January 31, 1970, and liquidated it by March 31, 1970. The purchase price was $3,780,550, and R. M. Smith assumed liabilities of $159,451. 93 and potential tax liabilities under Sections 1245 and 47 of $112,729. Before the liquidation, Gilmour sold certain assets to R. A. Gilmour for $280,550, which R. M. Smith received as cash. The parties disagreed on the calculations for refining the adjusted basis of the stock and its allocation among the assets received.

Procedural History

The case was initially heard by the U. S. Tax Court, which issued an opinion on January 31, 1977 (T. C. Memo 1977-23). Post-trial, conflicting computations under Rule 155 were submitted by both parties, leading to further proceedings. The court held a hearing on May 4, 1977, and issued a supplemental opinion on November 29, 1977, addressing the specific issues raised by the computations.

Issue(s)

1. Whether the total consideration paid for the stock, including assumed liabilities and potential tax liabilities, should be used to calculate the value of intangibles under the residual method?
2. Whether the addition to tax under Section 6653(a) should be included as an upward adjustment to the adjusted basis of the stock?
3. Whether the upward adjustment to adjusted basis for interim period earnings and profits should include the effect of Sections 1245 and 47 recapture?
4. Whether the receivable for prepaid Federal taxes should be treated as a cash equivalent, necessitating a downward adjustment to adjusted basis?
5. Whether the $280,550 received from the sale of assets to R. A. Gilmour should be

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treated as cash received, requiring a downward adjustment to adjusted basis?
6. Whether certain upward adjustments to adjusted basis should be offset with matching downward adjustments?
7. Whether the face amount of accounts receivable should be subtracted from the adjusted basis figure before allocation among the assets?
8. Whether the “globe and pylon” should be included as an asset received by R. M. Smith upon liquidation?
9. Whether the allocation of basis among the assets resulted in a “loss” for certain assets?

Holding

1. Yes, because the total consideration paid for the stock, including assumed liabilities and potential tax liabilities, represents the value of all assets acquired, and this total should be used to calculate the value of intangibles under the residual method.
2. No, because the addition to tax under Section 6653(a) was not a liability assumed as a result of the stock purchase and liquidation.
3. Yes, because the interim period earnings and profits adjustment should include the effect of Sections 1245 and 47 recapture, as these provisions would have applied regardless of the timing of the liquidation.
4. Yes, because the receivable for prepaid Federal taxes is equivalent to cash and should be treated as such for the purposes of adjusting the basis.
5. Yes, because the $280,550 was received as cash from the sale of assets to R. A. Gilmour before the liquidation, and thus should be treated as cash received.
6. No, because the regulations do not require offsetting upward adjustments with matching downward adjustments.
7. Yes, because the face amount of accounts receivable should be subtracted from the adjusted basis figure to prevent it from acquiring a basis in excess of its face amount.
8. No, because the record does not show that R. M. Smith acquired the “globe and pylon” upon liquidation.
9. No, because the allocation of basis did not result in a “loss” for the assets in question, as the basis assigned to accounts receivable was limited to its face amount, and the other assets were sold before liquidation.

Court’s Reasoning

The court applied Section 334(b)(2) and related regulations to determine the adjusted basis of the stock and its allocation among the assets. The court used the residual method to value intangibles by subtracting the fair market values of tangible assets from the total consideration paid for the stock, which included the purchase price, assumed liabilities, and potential tax liabilities. The court rejected the inclusion of the Section 6653(a) addition to tax in the adjusted basis, as it was not a liability assumed at the time of purchase. The court included the effects of Sections 1245 and 47 in the interim earnings and profits adjustment, as these would

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have applied regardless of the liquidation timing. The receivable for prepaid Federal taxes was treated as a cash equivalent, and the $280,550 from the sale to R. A. Gilmour was considered cash received, both requiring downward adjustments to the adjusted basis. The court also clarified that accounts receivable should not be allocated a basis exceeding its face amount, and the “globe and pylon” was not considered an asset received by R. M. Smith upon liquidation. The court emphasized that the allocation of basis did not result in a “loss” for the assets in question.

Practical Implications

This decision provides guidance on how to calculate and allocate the adjusted basis of stock in a Section 334(b)(2) liquidation. Tax practitioners should ensure that the total consideration paid for the stock, including assumed liabilities and potential tax liabilities, is used to value intangibles. The decision clarifies that certain tax additions, like Section 6653(a), should not be included in the adjusted basis, while the effects of Sections 1245 and 47 should be included in interim earnings and profits adjustments. The treatment of receivables as cash equivalents and the limitation of accounts receivable to their face amount are important considerations for basis allocation. This case has been cited in subsequent cases involving similar issues, such as *Florida Publishing Co. v. Commissioner* and *First National State Bank of New Jersey v. Commissioner*, demonstrating its ongoing relevance in tax law.

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