Orr v. Commissioner, 78 T. C. 1059 (1982); 1982 U. S. Tax Ct. LEXIS 77; 78 T. C. No. 75

The transfer of assets from a sole proprietorship to a controlled corporation, where liabilities assumed exceed the basis of the transferred assets, results in ordinary gain recognition under Section 357(c) of the Internal Revenue Code.

Summary

In Orr v. Commissioner, the Orrs transferred assets from their travel business, Schoolroom Tours, to a newly formed corporation, Schoolroom Tours, Inc. , in exchange for stock and the assumption of liabilities. The Tax Court held that this transfer resulted in ordinary gain under Section 357(c) because the liabilities assumed by the corporation ($716,802. 65) exceeded the adjusted basis of the transferred assets ($600,780. 18) by $116,022. 47. The court distinguished this case from Focht v. Commissioner, ruling that customer deposits were not deductible obligations and thus were liabilities for Section 357(c) purposes. This decision underscores the importance of considering the tax implications of liabilities when incorporating a business.

Facts

William P. Orr operated a travel business named Schoolroom Tours as a sole proprietorship in 1972. The business arranged vacation packages and operated on a cash basis. On February 22, 1973, Orr incorporated Schoolroom Tours into Schoolroom Tours, Inc. , transferring all assets except two real estate properties to the new corporation in exchange for stock and the assumption of liabilities. The liabilities included customer deposits on tours amounting to $716,802. 65 and accrued expenses of $8,820. 70. The total assets transferred had a basis of $600,780. 18.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Orrs' 1973 federal income tax, asserting that they recognized ordinary gain under Section 357(c) upon incorporation. The Orrs petitioned the U. S. Tax Court, which upheld the Commissioner's determination, though the amount of gain was reduced to $116,022. 47 based on concessions made during the proceeding.

Issue(s)

1. Whether the Orrs transferred all the assets of their sole proprietorship, Schoolroom Tours, to their controlled corporation, Schoolroom Tours, Inc. , in exchange for stock and the corporation's assumption of liabilities.
2. Whether the Orrs recognized ordinary gain under Section 357(c) of the Internal Revenue Code upon the incorporation of Schoolroom Tours.

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Holding

1. Yes, because the Orrs intended to transfer all assets except two real estate properties, and the corporation continued the business operations of the sole proprietorship.
2. Yes, because the liabilities assumed by the corporation ($716,802. 65) exceeded the basis of the transferred assets ($600,780. 18) by $116,022. 47, which is taxable under Section 357(c).

Court’s Reasoning

The court applied Section 351, which generally allows for non-recognition of gain upon the transfer of property to a controlled corporation. However, Section 357(c) requires recognition of gain when liabilities assumed exceed the basis of the transferred property. The court found that the Orrs transferred the assets of Schoolroom Tours to the corporation in exchange for stock and the assumption of liabilities, as evidenced by their intent expressed to their accountant and attorney. The court rejected the Orrs’ argument that customer deposits were not liabilities under Section 357(c), distinguishing them from the deductible obligations in Focht v. Commissioner. The court emphasized that customer deposits were not deductible when paid, unlike accounts payable, and thus were treated as liabilities for tax purposes.

Practical Implications

This decision affects how business owners should analyze the tax consequences of incorporating their businesses, especially when liabilities exceed the basis of transferred assets. It highlights the need for careful consideration of all liabilities, including customer deposits, when planning a corporate reorganization. The ruling also underscores the distinction between deductible and non-deductible liabilities for tax purposes. Subsequent cases and IRS guidance have applied or distinguished this ruling, particularly in the context of Section 357(c)(3), which was enacted to address the issues raised in Focht and similar cases.

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