

Background Facts

The material facts in this case are not in dispute and have been stipulated by the parties. In 1962, Old Camanowburg Skiing Corporation (Old Camanowburg) was formed in Michigan. Its sole business was the operation of a full-service ski facility, located outside Grand Rapids, Michigan. Russell and Mary Ann Russell, husband and wife, resided in Grand Rapids, Michigan, at the time they filed their petition. Russell was a shareholder of Old Camanowburg from 1967 until October 24, 1978, on which date he surrendered his 1,857 shares of Old Camanowburg stock for 3,233.2 shares of Brown-Schaefer stock. As of October, 1977, Old Camanowburg had 215,000 shares of authorized, common voting stock with a par value of one dollar per share. The outstanding stock was owned as follows:

Shareholder	Number of Shares	Percent Interest
William Goff	10,800	87.85
John D. Dunbar	3,750	1.74
John Schenck	1,750	0.81
Old Kent Bank as Trustee for Rosemary E. Thomas	5,000	2.34
Walter J. Russell	1,857	0.87
Total	118,157	100.00

On October 21, 1977, the owners of 98% of the Old Camanowburg stock (the Goff Group), excluding Walter Russell, agreed to sell their shares to Paul W. Brown, Prentiss M. Brown, Jr., and Roy A. Schaefer (the Brown Group). This agreement contemplated that the Brown Group would form a corporation, 100% owned by them, to which all the rights and obligations of the stock-purchase agreement would be assigned. On February 6, 1978, the Brown Group formed Brown-Schaefer Corporation under the laws of the state of Michigan. The corporation's stock was owned one-third each by the three principals. Its only assets were funds provided by the Brown Group to be used as a down payment for the Old Camanowburg stock. Pursuant to the October 21, 1977 Agreement, they assigned their rights and interests under the Agreement to their newly formed and wholly owned corporation. On May 5, 1978, Brown-Schaefer purchased approximately 98% of Old Camanowburg's outstanding shares and the Brown Group became the sole members of Old Camanowburg's board of directors. From the date of closing until October 31, 1978, Old Camanowburg was operated as a subsidiary of Brown-Schaefer. The remaining 2% of Old Camanowburg was owned by Russell. At the time Brown-Schaefer purchased its 98% interest, Russell was secretary and attorney for Old Camanowburg as well as a member of the board of directors. Russell, however, was not actively involved in the management of Old Camanowburg other than in his professional capacity as attorney. Negotiations that preceded the October 21, 1977 Agreement, the Brown Group's offer to purchase Russell's 2% interest in Old Camanowburg, 351*151. This offer to purchase was renewed at the time the 98% stock purchase was consummated. Because he desired to retain an equity interest in Old Camanowburg as an investment, however, Russell declined the offer on both occasions. On October 23, 1978, the board of directors of Old Camanowburg adopted unanimously a plan of reorganization. Pursuant to this plan, Russell was advised by letter that Brown-Schaefer desired to acquire his shares in exchange for its shares. In part, the letter read as follows:

"[R]eading that you have no desire to terminate your interest in ownership of the business operated by Camanowburg Skiing Corporation, we hereby offer to trade you shares of Brown-Schaefer Corporation for your Camanowburg Skiing Corporation common stock. In the event you fail to accept the offer, we will, of course, have Brown-Schaefer Corporation free to accomplish its purpose through other means."

On October 24, 1978, Russell accepted Brown-Schaefer's offer and surrendered his 1,857 shares of Old Camanowburg stock for 3,233.2 shares (approximately 7%) of Brown-Schaefer's outstanding common stock. As a result, Old Camanowburg became a wholly-owned subsidiary of Brown-Schaefer on October 24, 1978. On the same day, a special meeting of the board of directors of Brown-Schaefer adopted a Plan of Merger of Old Camanowburg into Brown-Schaefer. Effective October 31, 1978, Old Camanowburg was liquidated and merged into Brown-Schaefer, and Brown-Schaefer was renamed Camanowburg Skiing Corporation (New Camanowburg). Thereafter, New Camanowburg continued to operate the same business at the same location as had been operated by Old Camanowburg. At the time of the merger, Old Camanowburg had a basis of \$1,295,150 in its fixed assets. Immediately after the liquidation and merger, New Camanowburg reported a stepped-up cost basis of \$3,587,201. Old Camanowburg filed its final, unaudited income tax return for the short tax year from May 31, 1978 through October 31, 1978. For the 2% stock interest received from Russell, the return did not reflect any realized gain, but treated the stock exchange as a reorganization under section 368(a)(1) under which no gain would be realized and no recapture reported. New Camanowburg also attempted to carry back net operating losses incurred during its first year of operation to offset Old Camanowburg's net operating income for the year at issue. It also reflected its individual income tax return for 1978 reported no gain on the exchange of Old Camanowburg stock for Brown-Schaefer stock. Russell maintains that the exchange was a reorganization, and, as such, no gain had to be reported. On December 15, 1982, the Commissioner sent New Camanowburg a notice of liability and sent Russell a statutory notice of deficiency. Russell and New Camanowburg challenged these notices in Tax Court.

Analysis

Using this doctrine, the Tax Court found that the purchase of 98% of Old Camanowburg stock by the Brown Group, the exchange of Russell's shares for Brown-Schaefer stock, and the merger of Old Camanowburg into Brown-Schaefer should be treated as one transaction. Because this determination concerns the taxpayer's intent and is a question of fact, it will not be reversed unless it is "clearly erroneous."

Rule

Section 368(a)(1)(H) defines such a reorganization as follows: "the acquisition by one corporation, in exchange solely for all or part of its voting stock (or in exchange solely for all or part of the voting stock of a corporation which is in control of the acquiring corporation), of the stock of another corporation, if, immediately after the acquisition, the acquiring corporation has control of such other corporation."

Procedural History

Walter J. Russell and Camanowburg Skiing Corporation appealed the Tax Court's (T.C. Memo 1985-15) denial of their claim against the Commissioner. Taxpayers claim that they were wrongfully denied tax benefits when the Commissioner determined that a series of transactions by them constituted a complete liquidation under Section 312 of the Internal Revenue Code of 1954 (26 U.S.C.), that Section 314(b)(2) applied for purposes of calculating the basis of the corporation's assets, and that there was no reorganization under Section 368(a)(1) of the Code nor any tax-free contributions to capital under Section 351 of the Code.

Rule

To prevent easy evasions of the continuity of interest requirements, courts have developed the "step transaction" doctrine. Just last year, this Court adopted the "end result" test, holding that "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." *Brown v. United States*, 792 F.2d 559 (6th Cir. 1986).

Analysis

As the Tax Court noted, it is clear that the intent of the Brown Group, from the time it purchased 98% of the stock of Old Camanowburg, was to merge Old Camanowburg's assets into Brown-Schaefer with a stepped up basis.

Rule

Before any reorganization can be found to have occurred, however, the "continuity of interest" doctrine must be satisfied. Without a continuity of proprietary interest, there can be no tax-free reorganization.

Analysis

We agree with the Tax Court that the integration of the various steps taken by Russell and the Brown Group, which results in a 98% shift in ownership, clearly violates the identity of shareholders and their proprietary interests as required for an F reorganization. Because the requirements for an F reorganization have not been met, the exception found in Section 381(b) is not applicable.

Analysis

Because the requirements for a tax-free reorganization pursuant to Section 368(a)(1) were not met, Brown-Schaefer took a cost, rather than a carryover, basis in the stock purchased from Russell. As a result, there was increased depreciation and investment credit recapture. Furthermore, Russell must report the gain realized upon the sale of his stock.

Rule

Section 381(b)(3) of the Internal Revenue Code provides that a transferee corporation may not carry back a net operating loss generated in the taxable year after the transfer to a taxable year of the transferor "except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of Section 368(a)(1)."

Conclusion

We agree with the Tax Court and the Commissioner that Russell's exchange of Old Camanowburg stock for Brown-Schaefer stock cannot be amalgamated with the Brown Group's contribution of cash for Brown-Schaefer stock. In order to make such an amalgamation, we would have to find clearly erroneous the Tax Court finding that it was not the intention of the Brown Group, at the time the transaction was entered into, to include Russell as a shareholder of Brown-Schaefer. But, as the Tax Court observed, the Brown Group's repeated efforts to purchase Russell's stock shows the lack of intent to include Russell. We believe the Tax Court's finding to be sufficiently grounded in the evidence. Accordingly, we affirm the Tax Court's decision. Russell must report his realized gain on the exchange.