

Background Facts

These assets were acquired under these circumstances: In the early part of 1928 one Francis Quinn approached each of the three above companies, and also the Banner Machine Company and the Kuhlke Machine Company, with proposals for the transfer of their assets to a corporation to be organized, the plaintiff in this case. Contracts were entered into between him and each of these five companies, under which they agreed to convey all of their assets to this corporation for a certain amount in cash, the assumption of their liabilities, and the issuance to them of a certain number of shares of plaintiff's stock, except that the contract with the Kuhlke Machine Company provided for a transfer of only a portion of its assets to plaintiff, and none of its liabilities were assumed. Plaintiff was to have an authorized capital of 152,000 shares of common stock of no par value. 15,000 shares of it were to be issued to Francis Quinn for his services, and 35,000 shares were to be sold to J. A. Sisto & Company, bankers, at \$15 a share. The plaintiff was also to issue \$1,300,000 of first mortgage six percent bonds, which were to be sold to J. A. Sisto & Company at 90 percent of their par value.

Pursuant to these agreements, a total of 82,080 shares of plaintiff's stock were actually issued, 12,000 to the Akron Rubber Mold & Machine Company, 11,000 to the DeMattia companies, 4,000 to Banner Machine Company, 5,080 to Kuhlke Machine Company, 15,000 to Francis Quinn, and 35,000 to J. A. Sisto & Company.

The Commissioner of Internal Revenue held that this transaction was a reorganization and that the proper basis for depreciation of the assets received from the Akron Rubber Mold & Machine Company and the two DeMattia companies was the cost of those assets to those companies, and not to the plaintiff. But, on the contrary, he held that the proper basis for the assets received from the Banner Machine Company and the Kuhlke Machine Company was their cost to plaintiff, or, in the absence of proof of cost, their market value at the time plaintiff acquired them. This, he held, was for the reason that neither the Banner Machine Company nor Kuhlke Machine Company was a party to the reorganization. The Banner Machine Company was not a party to the reorganization because prior to the time it received the stock from the plaintiff it had made commitments for the sale of it and, in fact, did later sell it; the Kuhlke Machine Company was not a party to the reorganization because the plaintiff did not acquire "substantially all of the properties of the company."

Analysis

Unless, therefore, 80 percent interest or control remains in the same persons after the transfer, the proper basis is the cost to the plaintiff, and not cost to the persons who transferred the property to plaintiff.

Analysis

Deducting these 35,000 shares from the total shares issued, leaves only 47,080 shares, which is considerably less than the 80 percent fixed by the statute.

Analysis

Thus we see that while this section is applicable to the corporation transferring its property for stock, it is expressly made inapplicable to the corporation issuing its stock for property.

Rule

Paragraph (7), immediately following the above-mentioned paragraph, provides that the basis for the property received for stock in a reorganization shall be the same as it would be in the hands of the transferor, but only in the event that "immediately after the transfer an interest or control in such property of 80 per centum or more remained in the same persons or any of them." If such interest or control did not remain in such hands, then, of course, the general rule applied, to wit, cost.

Rule

In subparagraph (8) another case is described where cost to the seller is not the proper basis. This is where property is transferred by one or more persons to a corporation solely in exchange for its stock or securities and where immediately after the exchange the persons transferring the property are in control of the corporation in substantially the same proportion as their former interests in the property transferred. (The defendant concedes that for this section to be applicable, as well as subsection (7), the transferors must have not less than an 80 percent interest or control in the transferee corporation.)

Rule

Section 114 makes the basis for computing depreciation the same as the basis for computing gain or loss, and section 113 fixes cost as the ordinary basis for computing gain or loss on property acquired after February 28, 1913; but it sets out twelve exceptions to this general rule. Exception number (6) provides that if property was acquired in the manner this property was acquired, "the basis shall be the same as in the case of the property exchanged." This seems to support defendant's position; but the section concludes — "This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it."

Conclusion

It results that plaintiff is correct in saying the proper basis for the assets in question is their cost to it.