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THE LEGITIMACY OF BASIS FROM A CORPORATION'S OWN STOCK

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The Legitimacy of Basis from a Corporation's Own Stock

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When a corporation issues its own stock to acquire property in a transaction taxable to the seller, the corporation gets a basis for the acquired property equal to the fair market value of its stock.[1] Similarly, if a corporation issues stock to pay compensation or other current expenses, the corporation gets a deduction for the fair market value of the issued stock.[2]

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1. Burnet v. National Elec. Ticket Register Co., 55 F.2d 587 (8th Cir. 1932)(alternative rationale, since patent possibly acquired before 1913); Penney & Long, Inc. v. Comm'r, 39 F.2d 849 (4th Cir. 1930); Duncan Indus., Inc. v. Comm'r, 73 T.C. 266, 283-284 (1979); Moore-McCormack Lines, Inc. v. Comm'r, 44 T.C. 745, 757-758 (1965); Amerex Holding Corp., 37 B.T.A. 1169, 1188 (1938); MacCallum Gauge Co. v. Comm'r, 32 B.T.A. 544, 549-550 (1935); Ida I. McKinney v. Comm'r, 32 B.T.A. 450, 452 (1935); Pierce Oil Corp. v. Comm'r, 32 B.T.A 403, 430 (1935); Hazeltine Corp. v. Comm'r, 32 B.T.A. 4, 17 (1935); Ambassador Petroleum Co. v. Comm'r, 28 B.T.A. 868, 873 (1933); Farmers Cotton Oil Co. v. Comm'r, 27 B.T.A. 105, 115 (1932); Fifth Street Building v. Comm'r, 24 B.T.A 876, 885 (1931); Reliance Inv. Co. v. Comm'r, 22 B.T.A. 1287, 1289-1290 (1931); Mead Realty Co. v. Comm'r, 21 B.T.A. 1062, 1067 (1931); Seymour Mfg. Co. v. Comm'r, 19 B.T.A 1280, 1284-1285 (1930); D.O. James Mfg. Co. v. Comm'r, 17 B.T.A. 205, 210 (1929); Ben T. Wright, Inc. v. Comm'r, 12 B.T.A. 1149, 1151 (1928); John Glackner Realty Corp. v. Comm'r, 11 B.T.A. 151, 152-153 (1928); Realty Sales Co. v. Comm'r, 10 B.T.A. 1217, 1220 (1928); Rouse, Hempstone & Co., Inc. v. Comm'r, 7 B.T.A. 1018, 1024 (1927); George A. Giles Co. v. Comm'r, 4 B.T.A. 335, 339 (1926); Kennedy Constr. Co. v. Comm'r, 4 B.T.A. 276, 278 (1926); McIntosh & Seymour Corp. v. Comm'r, 2 B.T.A 953 (1925); Hub Dress Mfg. Co. v. Comm'r, 1 B.T.A. 197, 199 (1924); Rev. Rul. 56-100, 1956-1 C.B. 624; O.D. 955, 4 C.B. 44 (1921). *But cf.* Rev. Rul. 74-503, 1974-2 C.B. 117, 118 (subsidiary has zero basis in parent corporation stock because basis carries over from parent's zero basis in own stock), discussed *infra* notes 188 and 189 and accompanying text.

2. *See, e.g.*, I.R.C. §83(h) (employer has deduction for fair market value of stock included in employee's income); Treas. Reg. 1.83-6(a)(1)(1978) (issuing corporation may deduct stock compensation although gain on issuance is not recognized). Cases allowing a deduction for stock compensation before the enactment of section 83 include National Bellas Hess, Inc. v. Comm'r, 20 T.C. 636, 648 (1953), *aff'd*, 220 F.2d 415 (8th Cir. 1955); J.J. Hart, Inc. v. Comm'r, 9 T.C. 135, 139-140 (1947); Hudson Motor Car Co. v. United States, 3 F. Supp. 834, 846 (Ct. Cl. 1933). *Cf.* Hollywood Baseball Ass'n v. Comm'r, 42 T.C. 234, 270-271

The question is, why such a generous result? Why not zero basis and zero deductions? The corporation's basis and deductions are said to depend upon its "cost," when no nonrecognition or carryover basis provision applies.[3] To the issuing corporation, stock is cost-free, or at least it represents a de minimis outlay no larger than the cost of printing the certificates. As a general rule, basis represents the amounts that a taxpayer has invested but not yet deducted.[4] The fair market value basis commonly gives the acquiring corporation in a corporate reorganization a motive to violate some technical requirement for a reorganization.[5] If the reorganization status stands, the low basis that the target had in the appreciated property carries over as the acquiring corporation's basis.[6] If the reorganization fails, the acquiring corporation can get a step up in basis to the fair market value of the target property.[7] Why, if there is no reorganization, should a corporation receive a higher basis for the property it acquires by issuing stock than the printing costs it has not yet deducted?[8]

(1964) (amortization allowed for organizational expenses paid with the stock).

3. Treas. Reg. § 1.1032-1(d) (1960).

4. Except as otherwise provided, the basis of property shall be its cost. I.R.C. § 1012. Deducted costs are not part of basis (Treas. Reg. § 1.1016-2(a)(1960)) and basis must be adjusted downward as costs become deductible under depreciation allowances (I.R.C. § 1016(a)(2)). Basis can not in general include values that have not been previously subjected to tax. See text accompanying notes 30-35 and 61-65 *infra*. In practice, even the small costs of printing certificates are probably commonly deducted as housekeeping expenses of the corporation. Even if not, the fair market value of the stock, used for basis, will greatly exceed the trivial cost of printing the certificates.

5. *See* I.R.C. §368(a), defining "reorganization," and B.BITTKER & J.EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.51 (5th ed. 1987) (describing the nonstatutory judicial requirements for a reorganization)).

6. I.R.C. § 362(b).

7. *See, e.g.*, McDonald's Restaurants of Ill. v. Comm'r, 688 F.2d 520 (7th Cir. 1982) (acquirer gets fair market value basis for assets acquired in merger because target shareholders intent to sell acquirer's stock violated continuity of interest); Rev. Rul. 56-100, 1956-1 C.B. 624 (accord).

8. Sometimes the stock certificates used are treasury shares that were acquired by the corporation on the market for a cash cost. But using treasury stock is economically no different from issuing new stock on any point of substance and tax law seems to require that treasury stock be treated as if it were cancelled when acquired and newly issued when used. See Rev. Rul. 74-503, 1974-2 C.B. 117, 118. Section 1032, providing for nonrecognition of gain or loss by a corporation in exchange for its own stock, was enacted in 1954 to eliminate a distinction between newly issued stock and Treasury stock and to treat both under the nonrecognition treatment given under prior law to issuances of stock. When treasury stock was treated differently from stock that was cancelled and then reissued, a corporation could game the tax system by cancelling treasury stock that would produce a taxable gain, while using treasury stock that would generate a tax loss. See B. BITTKER & J. EUSTICE, *supra* note 5, ¶ 3.12.

There are several theories which purport to account for the fair market value basis rule: that it arises from the value or opportunity cost of the stock; that it arises because the property is the initial capital of the corporation; that the basis is necessary to preserve the tax exemption the corporation achieves under section 1032 for sale of its stock; that the basis is a carryover from the basis of the seller who receives the stock; or that basis is necessary to reach the same result that the corporation could obtain if it sold its stock for cash and used the proceeds of sale to buy the property or services. This Article, while accepting the fair market value basis rule, rejects these explanations for the reasons given in part I.

Instead this Article proposes to legitimate the fair market value basis rule with a present value theory. A corporation should have a fair market value basis for property acquired with its own stock because the stock represents a cost equal to the discounted present value of the cash that the corporation is expected to distribute on its stock in the future. The corporation by issuing its stock in a taxable transaction has committed a great deal of cash for business purposes and it should get basis or deductions for those business expenditures. The valuation process of discounting expected future cash flows at a post-tax interest rate insures that the value of the stock is a fair proxy for the cash that the corporation can be expected to expend in the future. Application of the present value theory legitimates some tax results, but implies necessary changes in others. Part II explains the present value theory and then applies it to various tax results.

The present value theory implies some amendments to current law, but even if it implied no change, the theory would be important. The historical defenses of the fair market value basis rule are nonsense, based on principles with no general applicability or on rules that were historical accidents and are no longer binding. More recent defenses either beg the question or are not compelling. Theory and legitimacy of tax results are important because we should be committed to changing unprincipled results and rooting out anachronisms. Care in the theory counts:

> The society that scorns excellence in plumbing because it is a humble activity and tolerates shoddiness in philosophy because it is an exalted activity will have neither good plumbing or good philosophy.

When this Article describes a corporation as "issuing stock," in any event, it intends to describe use of treasury stock as well.

Neither its pipes nor its theories will hold water.[9]

I. Rejected Theories for Fair Market Value Basis

This part presents and rejects the various theories that have been advocated to support a corporation's getting a fair market value basis from use of its own stock. Briefly stated, the theories and their rebuttals are as follows:

Value given. As a matter of history, the fair market value basis originated in an argument that a taxpayer's cost was the *value* of the consideration the taxpayer gave up. But cost basis is a tax concept that can not be identified in general with the value of what was given up. If basis always equaled the value of what was given up, it is difficult to see how any providing of services or selling property for fair value could produce taxable gain.

Initial Value Basis. "Basis" or "capital" was once thought to mean the value of the property at the time when the taxpayer received it, even when the taxpayer paid nothing for the property. But within a comprehensive tax system that attempts to tax economic gains, basis can not include unrealized appreciation not previously taxed. Fair market value basis, without prior tax, shields gain that is supposed to be taxed.

Preserving the tax exemption. One recent commentator has argued that a corporation must have a basis equal to the fair market value of property received for its stock as a way of preserving permanently the corporation's nonrecognition, accorded by section 1032, for sale of its stock. But section 1032 cannot in fact imply a fair market value basis, because the corporation often has a zero basis or carryover basis for property that constitutes its capital for good reasons consistent with the nonrecognition for sale of stock.

Carryover basis. In a taxable acquisition, stock given out increases recognized income or gain to the other party. But taxpayers do not ordinarily care about the tax results to a party on the other side of a taxable transaction. When the transaction fails to qualify as a section 351 transaction, as a reorganization or as a gratuitous contribution to capital, the party on the other side is a stranger to the corporation. Absent reorganization, the corporation's basis depends upon its own costs rather than costs of a stranger.

Circle of Cash. A corporation can achieve a fair market value basis under current law by selling its stock for cash and then using

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9. J. Gardner, Excellence 86 (1961).

the cash to acquire the property. If a fair market value basis can be achieved through self-help with a circle of cash, then giving less generous tax results for a direct issue of stock for property would plausibly just catch the unwary or unsophisticated taxpayer. But if zero basis for property acquired with stock is the right result, then the law can reach cash sales of stock consistently. The cash coming in can be treated, like nonshareholder contributions, as a reimbursement or recovery of investment, which reduces the corporation's net investment and hence its basis in assets.

A. *VALUE OF THE CONSIDERATION*

The rule that a corporation gets a fair market value basis for property acquired with its own stock arose, as a matter of history, because the stock was considered to be the corporation's cost for the property. Under the Treasury Regulations, a corporation has a cost basis for property acquired with its own stock, unless some explicit carryover basis provision applies.[10] "Cost" was first defined as equal to the fair market value of the stock under Treasury Regulations issued in 1918.[11] The Regulation provided that if a corporation's purchase price for capital assets "was paid by issuing stock," the purchase price was the actual value of the stock at the time it was issued in payment.[12] The courts accepted the rule.[13] By the 1930s the rule was said to be "well settled"[14] and a "long accepted way of determining cost."[15] Even courts expressing skepticism about the rule, went along on the basis of authority:

> While the stock so issued has no cost to and represented no outlay on the part of [the corporation], it has been held and may be regarded as settled that the cost to a corporation of property acquired through the issuance of its capital stock is the fair market value of

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10. Treas. Reg. § 1.1032-1(d) (1960) by reference to section 1012. The regulations have ample case law support. *See* cases cited *supra* note 1 and *infra* notes 13-17 and accompanying text.

11. Treas. Reg. 33 (Rev.), art 101, ¶ 367, 20 Treas. Dec. Int. Rev. 127, 182 (1918).

12. *See also* O.D. 955, 4 C.B. 44 (1921) ("cost price of the property . . . is the market value, on the date of the exchange, of the stock exchanged therefor[,]" but value could be derived by looking at the value of the corporation's assets if stock had no established market value) *declared obs.* Rev. Rul. 67-123, 1967-1 C.B. 383; I.T. 2041, III-1 C.B. 392, 393 (1924) (payment of stock for services "is equivalent to the payment in cash to the officer or employee of the corporation in an amount equal to the actual value of the shares of its stock . . . .").

13. *See* cases cited, *supra* note 1.

14. McKinney v. Comm'r, 32 B.T.A. 450, 456 (1935).

15. Reliance Inv. Co. v. Comm'r, 22 B.T.A. 1287, 1290 (1931).

the stock at the time of issue.[16]

The acquired property was apparently considered to have a cost equal to the value of the stock because, under common sense notions of cost, the stock was valuable consideration for the property. Payment in cash and payment with stock were considered to be the same. It was said, for instance, that a corporation "by the issuance of stock, paid for the assets it had acquired"[17] and that,

> Just as the cost of property purchased for cash is the amount of money given up for it, so it would seem to follow in a strict sense that the cost of property acquired in an exchange is what the recipient parts with, that is, the value of the [stock] given in the exchange.[18]

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16. Amerex Holding Corp. v. Comm'r, 37 B.T.A. 1169, 1188 (1938).

17. Unaka & City National Bank v. United States, 50 F.2d 1031, 1032 (6th Cir. 1931).

18. Myers Estate v. Comm'r, 1 T.C. 100, 111 (1942). In *Myers Estate*, the taxpayer, a shareholder, gave up some of his stock of his corporation in a previous exchange, receiving back bonds of the corporation. The taxpayer had reported the transaction as a tax-free reorganization, although the court found that the transaction should have been treated as a taxable exchange of stock for bonds. The court gave the taxpayer a fair market value basis, however, equal to the value of the stock he gave up, as if the taxpayer had reported gain on the exchange, on the argument, quoted in text, that the stock he gave up was like giving up cash for the bonds. *Accord*, Countway v. Comm'r, 127 F. 2d 69, 75 (1st Cir. 1942) (cost depends on fair market value of certificates given up: costs were neither more nor less by reason of taxpayer's treatment of the transaction on earlier return). *Cf.* Helvering v. Salvage, 297 U.S. 106 (1936) (property has basis equal to fair market value, even though employee erroneously never reported the property as taxable.). But as argued in the text accompanying *infra* notes 25-35, it makes no sense to give a taxpayer basis because of the value of consideration given.

The basis in cases like *Myer's Estate* has been justified, on other grounds, as a special result of the statute of limitations, which forgives prior sins once they have reached a certain vintage. Greenbaum, *The Basis of Property Shall Be The Cost of Property: How Is Cost Defined?*, 3 TAX L. REV. 351, 364, 373, 381 (1948) tries to justify the basis step up in *Myers Estate*, *Countway*, and *Salvage*, as necessary to prevent an indirect assault on the protection accorded by the statute of limitations. He concludes that how a transaction was previously reported on a tax return has nothing to do with cost. If step up in basis gives the taxpayer the benefit of an error, he argues, "the answer is that the statute of limitations presupposes the possibility of error and was intended to foreclose untimely reconsiderations." *Id.* at 381.

A taxpayer is given basis to prevent double tax of amounts previously taxed, *infra* note 30, but if the taxpayer included no amount previously he has no positive justification for basis from that source. Commissioner v. Farren, 82 F.2d 141, 142 (10th Cir. 1936) *dismissed per stip.*, 299 U.S. 617 (1936) (employee who failed to report stock compensation cannot get fair market value basis in the stock since the purpose of the basis is to prevent double taxation) and cases therein cited. When a taxpayer has a zero basis under normal tax principles, it is difficult to see how the fact that he acquired the property in a closed year adds anything to basis. A taxpayer can not claim a $100 basis for property he paid $50 for, for instance, just because he paid for the property in a year now barred by the statute of limitations. *See also* Orange Sec. Corp. v. Comm'r, 45 B.T.A. 24, 28 (1941) *aff'd*, 131 F.2d 662 (5th

The original regulation spoke of a purchase price "paid with stock."[19]

The Bureau of Internal Revenue stated in 1921 that "the cost price is the fair market value of the stock."[20] A corporation was also given a deduction for paying compensation with stock because, it was said, the liability to pay for services must be "translated into dollars and cents" based on the fair market value of the stock.[21] Consistently, in another area, an ex-wife receiving property in a divorce settlement was once considered to have a basis for the property equal to its value upon receipt because her giving up her marital rights was said to make her a "purchaser for fair consideration."[22]

The corporation's basis was also said to equal the corporation's "opportunity cost." " 'Cost,' " one commentator has argued, "is a concept which tax law has borrowed from the economist and accountant. It would appear to comprehend any sacrifice in money's worth that is made toward the acquisition of property purchased."[23] "Cost" to an economist, in a nontax sense, "is 'opportunity cost'—the benefit foregone by employing a resource in a way that denies its use to somebody else."[24] Thus the corporation using its stock was said to have a cost equal to the foregone oppor-

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Cir. 1942) (taxpayer characterization of transaction for basis must be consistent with his characterization of the receipt).

The issue has also been rendered less important by mitigation of the statute of limitations rules, which, while assuming a *status quo ante* that basis was produced by taxable events not reported as such, opens up the early year barred by the statute of limitations if there is a formal "determination" of the correct basis. I.R.C. §§ 1311-1314. *See also* J. DODGE, THE LOGIC OF TAX 28 (1989).

19. Treas. Reg. 33 (Rev.), art. 101, ¶ 367, 20 Treas. Dec. Int. Rev. 127, 182 (1918).

20. O.D. 955, 4 C.B. 44 (1921) (emphasis added).

21. Package Machinery Co. v. Comm'r, 28 B.T.A. 980, 986-88 (1933).

22. Farid-es-Sultaneh v. Comm'r, 160 F.2d 812, 815 (2d Cir. 1947) (divorcing wife achieves fair market value basis for property transferrred to her under prenuptial agreement because promise to marry and release from marital rights on divorce made her "a purchaser for fair consideration."); *accord* Rev. Rul. 67-221, 1967-1 C.B. 63. In United States States v. Davis, 370 U.S. 65 (1962), the Supreme Court held that a husband had to recognize gain on transfer of appreciated property to settle wife's claims in divorce. After *Davis*, the wife's fair market value basis could be explained as a carryover of the husband's basis, increased by his gain. These results were reversed by Congress in the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 421, 98 Stat. 494, 793, enacting I.R.C. § 1041, which provides for no gain to the transferring spouse and a carryover of the transferor's original basis to the receiving spouse.

23. Wurzel, *Tax Basis for Assorted Bargain Purchases or: The Inordinate Cost of "Ersatz" Legislation*, 20 TAX L. REV. 165, 175 (1964) (value of services rendered represents "legitimate element of cost"); Greenbaum, *supra* note 18, at 362 (cost of stock received as compensatory device is the value of the services rendered).

24. R. POSNER, ECONOMIC ANALYSIS OF LAW 6 (2d ed. 1977).

tunity to sell its stock to some other investor for its fair market value.[25]

But the theory that basis arises from the fair market value of the consideration given or from the taxpayer's opportunity cost can be reduced to absurdity. Suppose, for example, that I use my valuable services to paint a picture. Under the theory that basis is equal to the value of the consideration given up, I should have no gain on sale of the picture. I should be said to have purchased my picture for a cost equal to the fair market value of the services I put into the picture—just as a corporation has been said to have paid for property for consideration equal to the value of its stock. I have established the fair market value of my services by selling the picture because fair market value is defined as the price a stranger pays in an arm's length sale.[26] Assume that shortly after I paint my picture I sell it for $80 million.[27] Under the argument that basis is equal to fair market value of the consideration, I am entitled to the $80 million tax free.

Using opportunity cost as the cost basis for tax purposes might even generate some tax loss. Opportunity cost is the "benefit foregone by employing a resource in a way that denies its use to somebody else." Suppose that I ordinarily receive $550 million per year for my nonpainting services[28] and that I took a year to paint the $80 million picture. The basis of the painting, derived from opportunity cost, would be $550 million because by painting the picture I lost the opportunity to sell my nonpainting services for $550 million. The sale of my picture for $80 million cash would thus give me a $470 million tax loss for the year.

Under a rationale that the fair market value of what was given up establishes basis, it is difficult to see how any arm's length transaction could generate taxable gain. To receive fair wages, for instance, I must give up services to get them and the fair wages

25. *Cf.* Divine v. Comm'r, 500 F.2d 1041, 1057 (2d Cir. 1974) (corporation may deduct stock in computing earnings and profits because corporation suffered detriment of lost opportunity to sell stock to the public at its fair market value).

26. The standard definition of fair market value is: "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the facts." Treas. Reg. § 20.2031-1(b) (1963).

27. Reif, *$82.5 Million van Gogh Sets Auction Record*, N.Y. Times, May 16, 1990, at A1 (reporting auction sale of Van Gogh's *Portrait of Dr. Gachet* at a record $82.5 million).

28. Swartz, *Why Mike Milken Stands to Qualify for Guinness Book*, Wall St. J. at 1, col. 3 (March 31, 1980) (reporting that junk bond investment banker had compensation of $550 million in 1987).

presumably have no more value than the services given up. If basis is the consideration given up, then the amount realized in wages is no greater than the worker's basis. Similarly, when I sell Blackacre or some other property for cash, I receive cash in the amount of the sales price, but I must give Blackacre to get the cash. If the value of what I give up counts as "basis" to compute gain, then the basis and amount realized are equal. Basis, in sum, cannot generally equal the fair market value of the consideration given for the item.

Basis also arises from the prior taxation of property. If a taxpayer should win a car as a prize, for instance, the car would be taxable.[29] Literally, the car would have no cost to the taxpayer. But since the primary purpose of the basis account is to prevent a taxpayer from paying tax on amounts previously taxed, the taxpayer needs to be given an implied basis, despite the statutory language, equal to the value she has included in income.[30] But of course the theory that prior tax creates basis implies that the corporation should derive zero basis from use of its stock because a corporation never has income or gain from use of its own stock to acquire property.[31]

Basis for values not previously taxed leads to double deductions and underaccounting for the taxpayer's income. It is, for instance, well established that a cash method taxpayer gets no basis nor loss from amounts not previously included in income; a cash method taxpayer who has not paid tax on accounts receivable has no tax deduction if the receivables are never in fact received.[32] A

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29. I.R.C. § 74(a). *See also* Wills v. Comm'r, 411 F. 2d 537 (9th Cir. 1969) (car awarded to superstar baseball player was taxable); Hornung v. Comm'r, 47 T.C. 428 (1967) (*accord*, superstar football player).

30. Philadephia Park Amusement Co. v. United States, 126 F. Supp. 184, 188-89 (Ct. Cl. 1954). *Accord*, Smith v. Russell, 76 F.2d 91, 93 (8th Cir. 1935), *cert. denied*, 296 U.S. 614 (1935); Knight v. Comm'r, 28 B.T.A. 188, 190 (1933); Heninger v. Comm'r, 9 B.T.A. 1318, 1320 (1928); Keller, *The Taxation of Barter Transactions*, 67 MINN. L. REV. 441, 458-60 (1982); Brown, *The Growing "Common-Law" of Taxation*, 1961 S. CAL. TAX. INST. 1, 708.

31. I.R.C. § 1032.

32. I.R.C. §§ 165(b) & 166(b) (limiting loss and bad debt deductions to basis); Collin v. Comm'r, 1 B.T.A. 305, 308 (1925) (denying a cash method taxpayer a deduction when accrued interest was never in fact received) has the best explanation for the rule. Cases following the rule without much explanation include Hutcheson v. Comm'r, 17 T.C. 14, 19-20 (1951) (forfeited compensation not deductible because no basis); Seymour v. Comm'r, 14 T.C. 1111, 1116-1117 (1950) (no basis for forfeited compensatory stock); O'Meara V. Comm'r, 8 T.C. 622, 633-35 (1947)(royalties); Timken v. Comm'r, 47 B.T.A. 494, 496-99 (1942), *aff'd*, 141 F.2d 625 (6th Cir. 1944); Rains v. Comm'r, 38 B.T.A. 1189, 1196-99 (1938); Beekman v. Comm'r, 17 B.T.A. 643, 647-48 (1928) (uncollectable accounts receivable); J.D. Loizeaux Lumber Co. v. Comm'r, T.C. Memo 1947-177(P-H).

cash method taxpayer who discovers that he has had income embezzled from him in prior years has no deduction from the embezzled income if the embezzled income never previously appeared on his tax books.[33] As a matter of economics the taxpayer has lost the unpaid receivable or embezzled amounts, but as a matter of tax accounting, the cash method taxpayer does not pay tax on amounts never received and that is the sole and sufficient remedy. If cash method taxpayers were allowed a deduction for the fair market value they have lost when amounts are embezzled or debts go bad, then taxpayers would pay no tax on cash income they have retained and not lost, because the income would be offset by sheltering deductions.[34] Basis, in general, cannot include the fair market value of consideration given up if the values given up have not been previously included in income.[35]

Without better justification, the corporate deductions from use of stock seem like an inappropriate tax advantage. Cash used

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33. Alsop v. Comm'r, 34 T.C. 606 (1960); Teplitz v. Comm'r, T.C. Memo 1978-045(P-H).

34. Assume, for instance, that a taxpayer works in January for $1000 and in February works for another $1000, which is, however, embezzled by his agent before it shows up in his tax books. For the two months, the taxpayer has only $1000 in hand, which came from the January work, and since that $1000 is consumable or investable, it should be taxed. But assume that in April, the taxpayer discovers the February embezzlement and is allowed to deduct his $1000 fair market value loss at that time. Suddenly the April-February transaction would produce a $1000 loss deduction (rather than just no net income), which would shelter the $1000 January cash from tax. Exclusion in February of amounts never received is obviously correct. If the February $1000 had been entered in the tax books in February, a deduction in April to pull it out of the books would obviously be correct. But both the exclusion and an April deduction of a fair market value basis would misdescribe and misaccount for the facts. *See generally*, Crane, *Matching and the Income Tax Base: The Special Case of Tax Exempt Income*, 5 AM. J. TAX POL'Y 191, 217-23 (1986) (proposing "matching with prior source" as fundamental tax principle); DelCotto & Joyce, *Double Benefits and Transactional Consitency Under the Tax Benefit Rule*, 39 TAX L. REV. 473 (1984) (survey of the availability of double deductions in various contexts).

35. An argument that the "cost" basis language of the early statute left the courts no choice but to treat basis as the value given up should also be rejected. During the same period, without help from the statute, the courts were creating basis when a taxpayer previously included property in income (Heninger v. Comm'r, 9 B.T.A. 1318, 1320 (1928) and cases discussed, *supra* note 30, and accompanying text), were adjusting basis downward for depreciation taken (Even Realty Co. v. Comm'r, 1 B.T.A. 355 (1925)), and were denying a deduction for lost receivables when the receivables were not previously taxed (Collin v. Comm'r, 1 B.T.A. 305, 308 (1925)) and cases discussed, *supra* note 32 and accompanying text). Less constructively, the courts were also implying, without help from the statute, an initial value basis for property received at no cost. See cases cited and discussed, *infra* notes 41, 43, 45, 50 and accompanying text. The statutory language allowed sufficient room for good accounting and under good accounting, tax basis cannot in general include previously untaxed values.

for business expenditures will generate immediate deductions or basis, just as stock will. But cash by presumption comes from previously taxed sources; the tax benefits from the use of the cash do nothing but return to the corporation the tax that was originally imposed on the cash. A corporation's issuance of its own stock, by contrast, gives the corporation a source of funds that is already tax free. With both an exemption for issuing stock and deduction for issuing stock, a corporation can shelter unrelated income from tax. The double tax benefits improve the corporation's situation beyond a break even point to a tax shelter or negative tax position. A corporation subject to a 34 percent marginal rate using stock to pay an immediately deductible expense, for instance, will *add* 34¢ to the corporation's cash flow when the deduction is taken for every dollar of stock that it issues. If stock is so treated better than cash, by what policy reason does it get its advantage?

B. INITIAL VALUE BASIS

Early in the history of the income tax, it was commonly thought that the taxpayer's basis in property should equal the fair market value of the property as of the time the taxpayer received it. Treasury regulations issued in 1918, for instance, provided that a corporation's proceeds from the sale of its stock were "capital and not income."[36] Within the context of the time, that regulation plausibly meant not only that the corporation would have no tax upon issuing its stock, as section 1032 now provides, but also that the corporation would have a basis in property acquired equal to the fair market value of the property when acquired. At the time, "capital" was used as a near synonym for "basis."[37] There are a number of instances in which the initial value of the property upon receipt was considered to be the taxpayer's "basis." Taxpayers were commonly given an initial value basis, even for property received without any cost on their part.

An opportunity cost theory of basis, discussed in the last part, would derive basis from the value of the stock given out by the corporation. An initial value or capital theory would derive basis from the value of the assets received by the corporation. Even the original 1918 regulations just cited are inconsistent as to whether

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36. Treas. Reg. 33 (Rev.), art. 97, 20 Treas. Dec. Int. Rev. 127, 183 (1918).

37. *See, e.g.*, text accompanying *infra* notes 54-57 and accompanying text. *See also* Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918) (To determine gain, "capital value" must be subtracted from the gross proceeds).

the corporation has a fair market value basis, on the one hand, because the corporation's stock was its cost or, on the other hand, because the property it received was its capital.[38] When the stock and the property are exchanged exclusively for each other, it would seem as a matter of logic there should be no difference in value on one or the other side of the barter equation.[39] But the courts or commentators have sometimes found a difference between the value of the acquired property and the value of stock exchanged for it.[40]

For much of the early history of the income tax, the initial value basis was considered to be the normal or default rule, applicable in the absence of specific legislation to the contrary. The courts, for instance, gave corporations a tax-free step up in basis for appreciated property contributed by their owners. Before 1924 there was no explicit provision corresponding to current section 362(a) requiring a corporation to carry over the shareholders' basis in assets contributed to the corporation at the time of incorporation. In the absence of legislation, the courts gave the corporation a basis in the property equal to the fair market value of the property upon incorporation, notwithstanding that the incorporation was tax free to both shareholders and corporation.[41] In 1924, Congress

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38. Compare Treas. Reg. 33 (Rev.), art. 97, 20 Treas. Dec. Int. Rev. 127, 183 (1918) (proceeds of stock sale are "capital") with Treas. Reg. 33 (Rev.), art 101, ¶ 367, 20 Treas. Dec. Int. Rev. 127, 182 (1918) (purchase price for property was "paid by issuing stock").

39. Pittsburgh Terminal Corp. v. Comm'r, 60 T.C. 80, 88 (1973) (value of stock of corporation will necessarily be equal to property exchanged at arm's length).

40. Amerada Hess Corp. v. Comm'r, 517 F.2d 75 (3d Cir. 1975) *rev'g*, White Farm Equip. Co. v. Comm'r, 61 T.C. 189 (1973) (looking to value of stock to determine basis); Pierce Oil Corp. v. Comm'r, 32 B.T.A 403, 430 (1935)(*accord*); Kohl, *The Identification Theory of Basis*, 40 TAX L. REV. 623, 650 (1985) (arguing that value of the assets determined basis) discussed *infra* notes 89-116 and accompanying text.

41. Himelhoch Bros. & Co. v. Comm'r, 26 B.T.A. 541 (1932) (applying cost basis before 1924 and carryover basis thereafter); Fifth Street Bldg. v. Comm'r, 24 B.T.A 876, 885 (1931) (*accord*); D.O. James Mfg. Co., 17 B.T.A. 205, 211 (1929) (*accord*); Realty Sales Co. v. Comm'r, 10 B.T.A. 1217, 1220 (1928). The earliest cases giving the corporation a basis equal to the fair market value of the stock involved years in which there were no explicit nonrecognition provisions for corporations. Burnet v. National Elec. Ticket Register Co., 55 F.2d 587 (8th Cir. 1932) (transfer in 1912 or 1914); Penney & Long, Inc. v. Comm'r, 39 F.2d 849 (4th Cir. 1930) (1919 tax year); Mead Realty Co. v. Comm'r, 21 B.T.A. 1062, 1067 (1931) (1916 incorporation); Ben T. Wright, Inc. v. Comm'r, 12 B.T.A. 1149, 1151 (1928) (incorporation in 1917); Rouse, Hempstone & Co. v. Comm'r, 7 B.T.A. 1018, 1024 (1927) (1917 incorporation); Kennedy Constr. Co. v. Comm'r, 4 B.T.A. 276, 278 (1926) (1919 and 1920 transfers); McIntosh & Seymour Corp. v. Comm'r, 2 B.T.A 953 (1925) (1918 year). For those years, fair market value basis might have reflected gain reported by the shareholder in the incorporation. *Cf., e.g.*, I.R.C. § 362(a)&(b) which now increase the corporation's basis for gain recognized by the shareholder. But none of the early cases mentioned gain by share-

finally provided for a carryover basis where the corporation issues shares in a tax-free exchange for contributed property,[42] but even then the carryover basis provision was construed narrowly. Shareholders still sometimes accomplished a tax-free step up in basis if they gave property to their corporation without receiving back stock in exchange. In *Rosenbloom Finance Co. v. Commissioner*,[43] a shareholder contributed appreciated property to a family corporation, without taking back any stock. The Board of Tax Appeals (albeit not the Court of Appeals) gave the corporation a basis equal to the fair market value of the property when contributed. Perhaps more surprisingly, the Internal Revenue Service had itself previously ruled that a corporation's basis for bonds contributed to corporation as paid-in surplus was their value on date of contribution.[44]

Similarly, in a number of cases, the courts gave partnerships a basis for property contributed by partners equal "to the full extent of [the] value [of the property] at the time of contribution . . . ."[45] The courts gave a stepped up basis to the partnership even under abusive facts. In *Chisholm v. Commissioner*,[46] for instance, the taxpayers formed an investment partnership and contributed appreciated stock, solely to avoid their individual taxes on an immi-

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holders (if any was reported) as grounds for the fair market value basis to the corporation and the rejection of carryover basis, when it came up, was clear.

42. Revenue Act of 1924, ch. 234, § 204(a)(8), 43 Stat. 253, 259 corresponding to present I.R.C. §362(a)(1). *See* SEIDMAN'S LEGISLATURE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861 at 702 (1938).

43. 24 B.T.A 763, 772 (1931), *rev'd*, 66 F.2d 556 (3d Cir. 1933) (holding that transfer was a gift because no stock was received in return), *cert. denied*, 290 U.S. 692 (1933). This result is now governed by section 362(a)(2) providing for carryover basis. *See infra* notes 60, 63 and accompanying text for Congressional reversal of the result.

44. G.C.M 2861, VII-1 C.B. 255, 257-58 (1928).

45. Archbald v. Comm'r, 27 B.T.A. 837, 843 (1933), *aff'd per cur.*, 70 F.2d 720 (2d Cir. 1934), *cert. denied* 293 U..S. 594 (1934). *Accord*, Chisholm v. Comm'r 79 F.2d 14, 15 (2d Cir. 1935) (Hand, J.); Helvering v. Walbridge, 70 F.2d 683, 684 (2d Cir. 1934); United States v. Flannery, 106 F.2d 315 (4th Cir. 1939) (per cur.); Donner & Marine Trust Co. v. Comm'r, 32 B.T.A. 364, 371 (1935); Eaton v. Comm'r, 37 B.T.A. 715, 725 (1938). The result is now governed by section 723 providing carryover basis.

The courts in *Archbald* and *Walbridge* viewed the question as a mere timing issue—would the partners be taxed when the partnership sold the stock or only later (unless death intervened) when the proceeds were distributed? 27 B.T.A at 843; 70 F.2d at 684. Posing the question that way assumes that the partners did not get a fair market value basis as their outside basis in their partnership interest (notwithstanding that the consideration paid for their interest could be said to be the full value of the appreciated property they contributed). But prior to the enactment of section 722 in 1954, that assumption was "not so easily provable." A. WILLIS, HANDBOOK OF PARTNERSHIP TAXATION 69 (1st ed. 1957).

46. 79 F.2d 14, 15 (2d Cir. 1935) (Hand, J.)

nent sale of the stock. The court, speaking through Judge Learned Hand, still held that the partnership, which completed the sale, had a basis for the contributed stock equal to its value upon the contribution.[47]

In both the partnership and the corporation cases, the initial value basis was treated as a routine or normal rule, applicable without discussion in the absence of contrary legislation; once the courts rejected the government's arguments that some carryover basis provision applied, the initial value basis became the taxpayer's cost basis as a matter of course.

Taxpayers were also given an initial value basis for gratuitous transfers. The 1918 Treasury Regulations provided that the basis for property received by gift or inheritance was the fair market value of the property at the time of receipt.[48] In 1921 Congress replaced the initial value basis rule for gifts, requiring the donee to take a carryover of the donor's basis, but the Act changed the initial value basis only for gifts completed after 1920.[49] Even after 1921, the courts held that trusts had an initial value basis for gratuitous transfers made in trust.[50] Initial value basis survives to this day, at least as a "historical anachronism"[51] in section 1014, which provides for a basis for gratuitous transfers received by reason of death equal to the value of the property when received.[52]

Taxpayers also argued that initial value basis was a Constitutionally mandated rule, so as to defeat statutory provisions requiring a carryover basis from some other taxpayer. In *T.W. Phillips, Jr., Inc. v. Commissioner*,[53] for instance, the corporate taxpayer challenged the constitutionality of what is now section 362(a) of the Code, providing for a carryover of the shareholder's basis for property transferred to the corporation in a tax-free incorporation. The corporation argued that its capital was equal to the fair mar-

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47. *Id.* at 15.

48. Treas. Reg. 33 (Rev.), art. 4, ¶¶ 41,44, 20 Treas. Reg. Int. Rev. 127, 133 (1918). If the gift or inheritance was received before March 1, 1913, the value at March 1, 1913, determined basis, if it was higher than value at receipt.

49. Revenue Act of 1921, ch. 136, § 202(a)(2), 42 Stat. 227, 229. The stated purpose of the carryover was to prevent tax avoidance by a gift, for instance to a spouse, immediately before a sale. S. Rep. No. 275, 67th Cong., 1st Sess. 10-11 (1921).

50. Francis v. Comm'r, 15 B.T.A. 1332, 1340 (1929); Bankers Trust Co. v. Comm'r, 24 B.T.A. 10, 13 (1931), reversed retroactively to 1920 by Revenue Act of 1924, ch. 234, §204(a)(3), 43 Stat. 253, 258, which corresponds to current I.R.C. § 1015(b).

51. J. Dodge, *supra* note 18, at 336.

52. The stated reason for what is now section 1014, when enacted, was just to confirm the existing Treasury rule. S. Rep. No. 275, 67th Cong., 1st Sess. 10-11 (1921).

53. 63 F.2d 101 (3d Cir. 1933).

ket value of the property transferred to it upon incorporation and that Congress could not, under the Constitution, tax the corporation on the unrealized gain built into the property contributed to the corporation:

> The [corporation] takes the . . . position that it alone is the taxpayer; that as such its corporate entity cannot be disregarded or enlarged; that the [assets] it acquired in exchange for its stock were capital to the last dollar of their agreed value; that against no part of its capital so acquired and so measured can an income tax be lawfully levied and collected; that even if the capital so acquired include or reflect profits to the transferor, they cannot be assessed against and collected from the transferee, for that would be to tax one person for the income of another; and that, accordingly, the only profits lawfully to be taxed in this case are the difference between the capital cost of the [assets] to the [corporation] and their sale price . . . .[54]

The courts rejected the argument and upheld the constitutionality of the carryover provision,[55] saying, for instance, that carryover basis was part of a "well conceived scheme . . . permitting incorporations without taxation . . ., yet preventing a gain from escaping taxation when later it was actually realized by sale."[56] More generally, the courts in other contexts came to reject the arguments that the fair market value of property at some starting point was constitutionally protected, nontaxable capital.[57]

But while the courts rejected the constitutional challenges to the various carryover basis statutes, they also refused to find a car-

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54. 63 F.2d at 102 (citations omitted). *See also* Roberts, *Basis for Property Acquired for Stock*, 40 J. ACCT 100, 102 (1925) (arguing that predecessor of I.R.C. § 362(a)(1) carryover basis is unconstitutional because fair market value of contributed property constituted capital paid in and there was no constitutionally taxable profit on sale for that fair market value). *Cf.* F. PEARCE, INCOME TAX FUNDAMENTALS 346 (1937) (characterizing giving the corporation a basis of less than the fair market value of its stock as a "limitation of basis" and objecting to retroactive application).

55. T.W. Phillips, Jr., Inc. v. Comm'r, 63 F.2d 101, 102-103 (3d Cir. 1933); Newman Saunders & Co. v. United States, 36 F.2d 1009, 1010-11 (Ct. Cl. 1929), *cert. denied*, 281 U.S. 760 (1930); Osburn California Corp. v. Welch, 39 F.2d 41 (9th Cir. 1930), *cert. denied*, 282 U.S. 850 (1930). *See especially* Schweitzer & Conrad, Inc v. Comm'r, 41 B.T.A. 533, 545 (1940) (carryover basis of $588,000 in a reorganization was constitutional, although the acquiring corporation paid out consideration of over $2 million to acquire the property, including cash of $1 million paid to shareholders of the target).

56. *T.W. Phillips, Jr., Inc.*, 63 F.2d at 103.

57. Taft v. Bowers, 278 U.S. 470 (1929) (upholding now section 1015, providing that donee must take donor's basis); MacLaughlin v. Alliance Ins. Co., 286 U.S. 244, 251 (1932) (value of property as of March 1, 1913, was not exempted from income by the Constitution).

ryover basis without specific legislation. In *Unaka & City National Bank v. United States*,[58] for example, the court, over a vigorous dissent, refused to apply a Treasury Regulation that provided that the surviving corporation in a tax-free merger would step into the shoes of the disappearing corporation and carry over its tax basis in the transferred assets. The dissent argued that if a true merger existed, there was no purchase or sale of property upon which a new basis could be founded, so that of course the disappearing corporation's old basis must survive.[59] Under the majority decision, about a quarter of the transferor corporation's original basis disappeared without tax recognition.

Congress has repeatedly reversed the initial value basis rule. On at least five separate occasions between 1921 and 1934, Congress enacted legislation specifically to reverse an initial value basis that had been granted by the courts or regulations and to provide for a carryover basis instead.[60] The recurring pattern is that Congress or regulations would allow a taxpayer to receive appreciated property in some tax-free transfer, the courts or regulations would then allow a tax-free step up in basis to the value of the property at the time received, and Congress would step in to prevent abuse and require a carryover basis instead.

Congress in repealing the initial value basis was critical of the courts for allowing abuse. Congress said, for instance, that enactment of a carryover basis was necessary "to prevent tax avoid-

58. 50 F.2d 1031 (6th Cir. 1931).

59. *Id.* at 1033. *Cf.* Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 336 n. 414 (1988) (carryover basis for gifts was major innovation in 1920).

60. *See*, Treas. Reg. 33 (Rev.), art. 4, ¶¶ 41, 44, 20 Treas. Dec. Int. Rev. 127, 133 (1918) (basis in property received by gift or inheritance was value upon receipt), result changed by Revenue Act of 1921, ch. 136, § 202(a)(2), 42 Stat. 227, 229 corresponding to present I.R.C. § 1015; Francis v. Comm'r, 15 B.T.A. 1332, 1340 (1929) and cases cited *supra* note 50, reversed retroactively to 1920 by Revenue Act of 1924, ch. 234, § 204(a)(3), 43 Stat. 253, 258, which corresponds to present I.R.C. § 1015(b); Himelhoch Bros. & Co. v. Comm'r, 26 B.T.A. 541 (1932) and other cases cited, *supra* note 41, (corporation has a fair market value basis for property contributed upon incorporation), result changed by Revenue Act of 1924, ch. 234, § 204(a)(8), 43 Stat. 253, 259 corresponding to present I.R.C. § 362(a)(1); Rosenbloom Finance Co. v. Comm'r, 24 B.T.A 763 (1931), *rev'd*, 66 F.2d 556 (3d Cir.), *cert. denied*, 290 U.S. 692 (1933), result changed by Revenue Act of 1932, ch. 277, § 113(a)(8), 48 Stat. 683, 707 which is the predecessor of current I.R.C. §362(a)(2); Archbald v. Comm'r, 27 B.T.A. 837, 843 (1933), *aff'd per cur.*, 70 F.2d 720 (2d Cir. 1934) *cert. denied*, 293 U.S. 594 (1934) and cases cited, *supra* note 45 (partnership has basis for contributed property equal to value when contributed), result changed by Revenue Act of 1934, ch. 277, § 113(a)(13), 48 Stat. 683, 707, which is the predecessor of I.R.C. § 723.

ance,"[61] "to make specific the *correct* interpretation of the general provisions of present law,"[62] to prevent an "*unexpected* avenue of tax avoidance,"[63] or to prevent taxpayers from using nonrecognition provisions "to escape *proper* taxation by increasing basis."[64] In 1924, the Staff, explaining the enactment of what is now section 362(b), was especially critical of the reasoning that allowed a tax-free step up in basis in reorganizations:

> The theory underlying the provisions [for nonrecognition for reorganizations] is that in substance there has been no real change which would result in a realization of profit by the corporations or by their stockholders. The same theory should be applied in determining the basis of the assets transferred in connection with the reorganization. If the new corporation is in substance the same as the old, the basis for determining gain or loss and for depreciation and depletion of the assets of the new corporation should be the same as the basis of those assets in the hands of the old corporation prior to the exchange.[65]

Given the abuses, it is the curious perseverance of initial value basis that needs explanation. There is no sure explanation of the continued attraction of the courts and regulations to the rule. Both cases and commentators assume that the taxpayer's "capital" must be initial value, without attempting to justify the rule. But there are at least three related arguments afield in the early decades of the income tax that give some intellectual support to the rule.

First, initial value basis might have been just an overgeneralization from early cases that gave taxpayers a initial value basis to prevent taxation of appreciation that had occurred before the effective date of the income tax. Early in the history of the income tax, taxpayers were given a basis for property, held before the tax, of at least the value of the property on the effective date of the

61. S. Rep. No. 275, 67th Cong., 1st Sess. 10-11 (1921) reporting on Revenue Act of 1921, § 202(a)(2), enacting the predecessor of I.R.C. § 1015.

62. H.R. Rep. No. 704, 73d Cong., 2d Sess. 18 (1934); S. Rep. No. 558, 73d Cong. 2d Sess. 18 (1934) (emphasis added), reporting on Revenue Act of 1934, § 113(a)(13), which is the predecessor of I.R.C. § 723.

63. H.R. Rep. No. 708, 72 Cong., 1st Sess. 6 (1932) (emphasis added), reporting on Revenue Act of 1932, § 113(a)(8), which is the predecessor of I.R.C. § 362(a)(2).

64. S. Rep. No. 398, 68th Cong., 1st Sess. 7 (1924); H.R. Rep. No. 179, 68th Cong., 1st Sess. 7 (1924) (emphasis added), reporting on the Revenue Act of 1924, § 204(a)(8) corresponding to present I.R.C. § 362(a)(1).

65. Statement of the Changes Made in the Revenue Act of 1921 by H.R. 6715 and the Reasons Therefor, 68th Cong., 1st Sess. 13 (Comm. Print March 6, 1924).

income tax.[66] In 1918 in *Doyle v. Mitchell Brothers*,[67] the Supreme Court gave a corporation a basis equal to the value of the property as of the effective date of the 1909 corporate tax, which was the precursor to the general federal income tax. The Court's language sounds like a general explanation for all basis:

> In order to determine the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.[68]

The Supreme Court later held that Congress had the Constitutional power to tax gains accruing before the effective date of the income tax if the gains were realized after the income tax became effective.[69] But early commentators thought that the exemption of pre-effective date gains was a Constitutional rule and not just a rule of statutory construction and they treated the rule with tremendous respect.[70] In 1921, the taxpayer, in unsuccessfully chal-

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66. The rule giving the taxpayer a basis equal to the fair market value of the property at the effective date for the tax originates in Treasury Regulations promulgated under the 1909 corporate tax that was the precursor to the modern federal income tax. These regulations provided that for property bought before the January 1, 1909, effective date of the tax, "the difference between the selling and buying price [for the property] is to be adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1, 1909." Treas. Reg. 31, art. 2, ¶ 5, T.D. 1571, 12 Treas. Dec. Int. Rev. 131, 137-38 (1909). The Supreme Court upheld the rule under the 1909 Act in Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918) and Hays v. Gauley Mountain Coal Co., 247 U.S. 189 (1918). When the general federal income tax was adopted in 1913, the courts relied heavily on the prior construction of the 1909 Act and gave taxpayers a basis for property equal to the fair market value as of the March 1, 1913, effective date of the tax. Lynch v. Turrish, 247 U.S. 221 (1918); Southern Pacific Co. v. Lowe, 247 U.S. 330, 335 (1918). The rule is now codified in section 1053.

67. 247 U.S. 179 (1918). The year of the decision, 1918, is the same year as the regulations first establishing fair market value basis for property acquired with the corporation's stock. See *supra* note 36.

68. *Id.* at 185.

69. MacLaughlin v. Alliance Ins. Co., 286 U.S. 244, 250 (1932) (application of 1928 tax provisions on insurance company investments). *Accord*, Norman v. Bradley, 173 Ga. 482, 160 S.E. 413 (1931)(affirmance by equally divided court) *appeal dismissed per curiam* for want of a substantial federal question *sub. nom.* Glenn v. Doyal, 285 U.S. 526 (1932) cited with approval by *MacLaughlin* (Georgia income tax on gains from sale of corporate stock, accrued before but realized after effective date of Georgia income tax, was constitutional). *Cf.* United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 96 (1936)(no constitutional protection for claims unfixed as of March 1, 1913, with criticism of taxpayer claims that all March 1, 1913, values were constitutionally protected capital).

70. G. HOLMES, FEDERAL TAXES 497 n.78, 509, n.57 (1923 edition) (gain could not constitutionally be taxed; exemption founded on the Constitution); J. KLEIN, FEDERAL INCOME TAXATION 869 (1929) (there is a constitutional limitation upon the power of Congress to tax pre-enactment gain); Even Realty Co. v. Comm'r, 1 B.T.A. 355, 364 (1925) (cost or March 1, 1913, basis decided on "constitutional ground and not any rule of construction"). *Cf.* Rob-

lenging the constitutionality of the then new carryover basis provisions (now section 1015) for gifts, tried to establish a link between the March 1, 1913, basis and an initial value basis for gifts.[71] The taxpayer argued that there was no distinction between appreciation occurring before the enactment of the income tax and appreciation occurring before the donee received the property.[72] The Court rejected the Constitutional challenge, without however addressing the validity of the link.[73]

Consistently, Professor Potts has argued that the rule that basis is equal to the March 1, 1913, value of the property was at first considered to be the general rule and that the taxpayer's cost was just an afterthought:[74] The first statutory definition of "basis," enacted in 1916, in fact, gave taxpayers a basis equal to fair market value of the property as of the March 1, 1913, effective date of the income tax.[75] Cost basis, which is now the general rule, was added only three years later in 1919.[76] Professor Potts argues that "basis," as tax term of art, came over from the non-term-of-art use of "basis" meaning "foundation" or "starting point."[77]

Whatever the wisdom (or folly) of exempting pre-1913 appre-

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erts, *supra* note 54, at 102 (fair market value of contributed property constituted capital paid in and there was no profit, consitutionally taxable, on sale for that fair market value); United States v. Guinzberg, 278 Fed. 363, 363 (2d Cir. 1921) (exempting dividends on grounds that they were out of profits accrued to corporation prior to March 1, 1913). *See also* J. HENDERSON, INTRODUCTION TO INCOME TAXATION 96 (1943) (still asserting the "inapplicability of the sixteenth amendment and of income taxation to a mere return of capital.").

71. Taft v. Bowers, 278 U.S. 470 (1929).

72. 278 U.S. at 471-72.

73. The Court upheld the carryover basis, saying that Congress had the power to "require a succeeding owner, in respect of taxation to assume the place of his predecessor." The carryover seemed to the Court to be "entirely appropriate for enforcing a general scheme of lawful taxation." *Id.* at 482-83.

74. Potts, *Did Your Law Professor Tell You Basis Means Cost?: The Recognition Theory of Basis*, 22 VALPARAISO L. REV. 233, 241 (1988).

75. Revenue Act of 1916, ch. 463, § 2(c), 39 Stat. 756, 758 corresponding to I.R.C. § 1053.

76. Revenue Act of 1918, ch. 18, § 202, 40 Stat. 1057, 1060 (1919) which is the predecessor to I.R.C. § 1012.

77. Potts, *supra* note 74, at 242, citing, for instance, Even Realty Co. v. Comm'r, 1 B.T.A. 355, 358 (1925). *But see* Treas. Reg. 33, art. 144, 16 Treas. Dec. Int. Rev. 65 (1913) (corporation shall "base" depletion deductions upon cost, not estimated value of the oil and gas, indexed under "Deductions—basis, depletion").

The association of the term "basis" with initial value, in any event, appears to have become a fairly common confusion. Black's Law Dictionary, for instance, still defines "basis" as a "[t]erm used in accounting, especially in tax accounting, to describe the *value* of an asset for purpose of determining gain (or loss) on its sale or transfer . . . ." BLACK'S LAW DICTIONARY 138 (5th ed. 1979) (emphasis added).

ciation from tax,[78] that decision should not have been generalized to immunize from tax appreciation that arose fully within the chronological jurisdiction of the income tax. As March 1, 1913, receded in time, the 1913 basis became increasingly moot, and the other initial basis rules, the illegitimate progeny of 1913 basis, became far more important than the progenitor rule itself.[79] Giving the taxpayer an initial value basis on property received in a tax-free transfer prevents the government from taxing the appreciation occurring before the property was received by the taxpayer. With an initial value basis rule, any untaxed transfer from one taxpayer to another, such as by gift or contribution, strips the property of all of its prior taxable gain and allows the parties to start over. It is difficult to see, at least in retrospect, why such a stripping of gain should ever have been implied or allowed as a normal way of accounting for gain, at least within an income tax that claims to be comprehensive.

Second, initial value basis might be just a borrowing from non-tax accounting. Under generally accepted accounting principles, a firm's basis in assets contributed by its owners is the fair market value of the assets at the time contributed.[80] Excluding the precontribution appreciation (or decline) of property is important to non-

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78. The basis for March 1, 1913, value is arguably a wise demarcation of the chronological borders of the income tax. Owners who experienced gains before that point might reasonably have expected to have no tax on their appreciation. On the other hand, the gain was realized only within the jurisdictional scope of the tax and was part of the taxpayer's realized profit, standard of living, and ability to pay tax during the year's covered by the tax. *See also* United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 96 (1936)) (disapproving of tendency "now and again to look upon March 1, 1913 as fixing a point of time when claims of every kind, no matter how contingent, became transmuted into capital").

79. To give another example, the earnings and profits limitation on dividends (criticized in authorities cited *infra* note 210) "crept into the federal income by accident when Congress was establishing March 1, 1913 as a dividing line between taxable distributions and nontaxable [capital.]" B. BITTKER & J. EUSTICE, *supra* note 5, ¶ 7.03; Blum, *The Earnings and Profits Limitation on Dividend Income: A Reappraisal*, 53 TAXES 68, 81 (1975) (*accord*). See United States v. Guinzberg, 278 Fed. 363, 363 (2d Cir. 1921) (exempting dividends on grounds that they were out of profits accrued to corporation prior to March 1, 1913).

80. ACCOUNTING PRINCIPLES BOARD, APB STATEMENT NO. 4, BASIC CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES ¶ 4 (1964) (measurement of owner's investment is based on fair market value of the transfered assets). *See* Roberts, *supra* note 54, at 100, 102 (arguing that no part of sale price represents profit, when sale price was equal to fair market value of property contributed as paid in capital). *Cf.* Patten, *Partnerships*, in ACCOUNTANT'S HANDBOOK 41-6 (L. Seidler & D. Carmichael eds., 6th ed. 1981) (initial balance sheet should assign fair market values to asset contributed to the partnership).

tax accounting. Accountants are charged with the job of computing an income or earnings figure that is a fair reflection of the performance of the firm. Appreciation in the value of property before the firm owned the property is not part of the firm's performance, but must be attributed to events and to the owners apart from the enterprise. Earnings by the firm are over and above the initial contribution.

Nontax accounting would in fact require a restatement of assets up to their fair market value every time there was need to keep new separate books for some new endeavor or subdivision of the enterprise and even if there was no change even in nominal ownership. A sole proprietorship, for instance, also states assets at their initial value upon contribution.[81] Restatement of the assets would be necessary to distinguish the separate performances of the old and new endeavors.

The initial value basis that makes so much sense for nontax accounting, however, is nonsense for tax accounting. If assets could be stepped up so easily for tax purposes, just by deciding to keep new separate books for some new endeavor or subdivision of an enterprise, and without tax recognition of the unrealized gain, it is difficult to see why anyone would pay tax on any gains. Taxpayers would simply restate their basis immediately before sale.

Third, and probably the strongest source contributing to initial value basis, is the ambiguity, early in the income tax, whether the term "capital" was intended to refer to a physical thing, that is to the property or *res*, or to a monetary account, that is, the amount originally invested.[82] Basis, to be immunized from tax, is now a monetary account, which usually starts from what the taxpayer has invested or paid tax on. Under earlier notions, however, the taxpayer's capital was commonly identified with the property itself, whatever its value. Under early British property and trust law, gains from the sale of capital assets were excluded from income. The idea arose under feudal systems when most wealth was land, when most land was entailed, and when sales of the land were rare. The land itself was the corpus or capital that had to be

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81. S. GILMAN, ACCOUNTING CONCEPTS OF PROFIT 61-63 (1939).

82. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397, 412-20 (1987); Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got To Do With It?*, 39 SW. L.J. 869 (1985); L. SELTZER, THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES 26-35 (1951). *Cf.* Isaacs, *Principal—Quantum or Res?*, 46 HARV. L. REV. 776 (1933) (discussing ambiguity of whether capital refers to property or cost invested, primarily as to trust accounting).

preserved for the remainderman; only the fruits of the land, *i.e.*, the annual harvests, could be distributed to and consumed by the life tenant or income beneficiary. The land, or later other capital asset analogous to land, remained corpus or capital no matter how much it was worth. Proceeds from the sale of the land or other capital asset would either be reinvested in full into new income-producing property or would be distributed to the holder of the corpus interest. The capital asset, whether held or sold, was never distributable to the income interest.[83]

It was not until 1921 that the Supreme Court finally settled that the federal income tax could tax the gains from the sale of capital assets.[84] Even after 1921, the trust and feudal property concepts, giving protection to capital whatever its value, would have had influence because they were familiar, whereas accounts more appropriate to the new income tax, *i.e.*, the basis account tracing the tax history of the asset, were still unfamiliar.[85] The cases holding that gifts in trust were not subject to the carryover basis provisions, even after Congress provided that gifts had a carryover basis to the donee,[86] indeed seem intelligible only within the context of older trust concepts that treated the corpus property as capital rather than income.

But once it was settled that the federal tax was to apply to economic gains on investment or corpus property, when the property was actually sold, then ancient notions of capital had to be abandoned.[87] The basis account for tax purposes has to exclude previously untaxed appreciation if that appreciation is ever to be taxed. Basis is now an account to keep track of the amount of the taxpayer's after-tax investment.

At this point in the history of the income tax, moreover, the fact that an item is capital generating an investment return is a

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83. L. SELTZER, *supra* note 82, at 26-35; Kornhauser, *supra* note 82, 45 SW. L.J. at 893-96, 901.

84. Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921) (lead case); Walsh v. Brewster, 255 U.S. 536 (1921); Goodrich v. Edwards, 255 U.S. 527 (1921); Eldorado Coal & Mining Co. v. Mager, 255 U.S. 522 (1921).

85. *See, e.g.*, R. MAGILL, TAXABLE INCOME 41 (rev. ed. 1945) (lawyers trained to view land as corpus find the broad "res" theory of capital to be natural); Kornhauser, *supra* note 82, 45 SW. L.J. at 893-94.

86. See *supra* note 50.

87. *See, e.g.*, Taft v. Bowers, 278 U.S. 470 (1929) (upholding the carryover basis now found in I.R.C. § 1015), where the taxpayer argued that the value of the gift at the time of receipt was "capital in the hands of the donee" (*id.* at 471), but the court responded that there was "only a single *investment* of capital—that made by the donor." (*id.* at 482).

better reason for taxing the item than for excluding it from tax. In a tax system that identifies true income, a taxpayer makes and continues investments only with post-tax "hard money" amounts. The ability to make or continue investments with untaxed or "soft money" amounts is an advantage within an income tax system that is usually as advantageous as not having to pay tax on the subsequent income from the investment. The investor is normally indifferent between exempting income from tax or exempting the capital invested from tax. To make the income tax system neutral between investments, all capital should be subject to tax.[88]

In sum, whatever was appealing about the initial value basis in the early history of the income tax now seems to be unappealing. A general initial value basis is at best an erroneous anachronism, an anomaly within a generally comprehensive income tax.

C. PRESERVING THE TAX EXEMPTION

In an argument reminiscent of initial value basis, Glenn Kohl has recently argued that a corporation should have an initial value basis for property acquired with its own stock to preserve the exemption from tax, provided by section 1032, for a corporation selling its own stock.[89] Corporations issuing stock recognize neither gain nor loss when they issue stock, he argues, "based on the view that amounts received in exchange for stock do not constitute income." "The transaction was considered to be a nontaxable capital transaction," he says, "whereby a corporation acquired its invested capital."[90] He categorizes the issuance of stock under section 1032 in a transaction taxable to the receiving shareholder as a transaction for which tax exemption should last forever,[91] as distinguished from a "deferred tax transaction" on which no gain is recognized, but for which tax is deferred for some temporary period until a subsequent realization event.[92] Failure to award the corporation a fair market value basis in the property would, in his view, result in an illicit tax, were the corporation to sell the property, on what is supposed to be exempt income.[93] He reads section 1032 as properly giving a fair market value basis, just as section 1014 gives fair mar-

88. *See, e.g.*, Johnson, *Soft Money Investing under the Income Tax*, 1989 ILL. L. REV. 1019 (1990).

89. Kohl, *supra* note 40.

90. *Id.* at 643.

91. *Id.* at 648.

92. *Id.* at 624.

93. *Id.* at 629, 642.

ket value basis to bequests received tax free under section 102.[94]

For Kohl, the corporation's basis has nothing to do with its cost or the value of stock given out. "A corporation incurs no cost upon the issuance of its stock," he says, "which is a claim against itself."[95] He is critical of a case in which the taxpayer lost a very significant amount of basis because the Court used traded value of the stock given out to establish basis, whereas in his view it should have used the market value of the assets acquired with the stock.[96]

There are some kinds of tax-exempt receipts which should indeed generate a basis for the property received. Section 104(a)(2), for example, exempts damages received on account of personal injuries. If a tortfeasor transfers appreciated property to settle a personal injury tort claim, the settlement property is received tax free by the tort victim. We would also expect the tort victim would be able to sell the property immediately and pay no tax, notwithstanding that the property had appreciated in the tortfeasor's hands.[97] The tort victim's basis should equal the fair market value of the property when received.[98]

It is difficult, however, to deduce a fair market value basis

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94. *Id.* at 642-643. "Unfortunately[sic], section 1014, the fair market value basis provision applicable to tax significant section 102 transactions (bequests), has no counterpart applicable to those section 1032 transactions that are tax significant."

95. *Id.* at 648. Kohl cites E.R. Squibb & Sons v. Helvering, 98 F.2d 69, 71 (2d Cir. 1938) (Hand, J.) *modified* 102 F.2d 681 (2d Cir. 1939) for the proposition that stock is *not* an obligation of the corporation, whereas *Squibb* in fact treats the stock as an obligation on a par with debt obligations.

96. *Id.* at 650 citing Amerada Hess Corp. v. Comm'r, 517 F.2d 75 (3d Cir. 1975), *rev'ing*, White Farm Equip. Co. v. Comm'r, 61 T.C. 189 (1973). Contrast, for instance, Pierce Oil Corp. v. Comm'r, 32 B.T.A 403, 430 (1935), where the court decided looking at the value of the assets acquired for the stock, as only a "makeweight or as a last resort." *See also* Pittsburgh Terminal Corp. v. Comm'r, 60 T.C. 80, 88 (1973) (value of stock of corporation will necessarily be equal to property exchanged at arm's length).

97. We would also expect the tort defendant to recognize the gain on the property transferred in settlement in part because the transferee would not pay the tax on the gain. United States v. Davis, 370 U.S. 65 (1962) (husband taxed on gain on property transferred to settle divorce claims). Tax-free step ups should not be implied. Both the transferor and transferee should settle the claims in post-tax currency.

98. Similarly if a municipality paid tax-exempt interest in the form of property, the bondholder should have an initial value basis in the property. *See, e.g.*, I.R.C. § 705(a)(1)(B) increasing a partner's basis in his partnership interest by his share of the tax-exempt income received by the partnership. The increase in basis, and the rules allowing partnership distributions to be applied first against basis (I.R.C. § 731(a)(1)), mean that the partner may receive distributions of the tax-exempt interest without paying tax upon the distribution. Contrast, Treas. Reg. § 1.312-6(b) increasing corporate earnings and profits by tax-exempt interest received by the corporation so that the interest, "although not taxable when received by the corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends."

from the tax exemption given to a contribution to corporate capital, however, because corporations commonly have a zero basis or a carryover basis for property received tax free as a contribution to their capital. Both the zero basis and carryover basis are fully consistent with a coherent rationale for exemption of the corporation's receipt.

If, for example, a nonshareholder (or shareholder not acting as such) contributes property to the capital of a corporation, the corporation has a tax exemption for the contribution.[99] But the corporation has no net cost for the contributed property and, under section 362(c), it thus has zero basis in the property. The corporation, while receiving the property tax free, is not credited with an "investment it has refused to make."[100] Sometimes the corporation is best viewed as a mere custodian for the property and not as its real tax owner. When the property was contributed by the nonshareholder for the benefit of the general public or for the benefit of the contributor, the corporation is a mere custodian, who has neither income from nor basis in the property.[101] If the nonshareholder contribution is in cash, the receipt of the cash is still tax free, but the cash then reduces the corporation's basis in some asset.[102] The nonshareholder's cost is both tax exempt to the corporation and also a reduction of the corporation's cost because it is considered to be a reimbursement of the corporation's cost.[103] Both

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99. I.R.C. § 118. *See also* Edwards v. Cuba R.Co., 268 U.S. 628 (1925) (contribution to capital is not income).

100. Detroit Edison Co. v. Comm'r, 319 U.S. 98, 103 (1943).

101. *See* United States v. Chicago, B.& Q.R.Co., 412 U.S. 401 (1973)(railroad has zero basis in assets given to it by various governments, prior to enactment of section 362(c), because governments gave or constructed underpasses, crossings, and other facilities for safety and benefit of the general public and not for the private welfare of the railroad).

102. I.R.C. § 362(c)(2); Treas. Reg. § 1.362-2(a)(1977). Cash subsidies not earmarked or identified with specific property reduce the corporation's basis under a set of automatic rules that usually first reduce the taxpayers basis in all depreciable properties acquired in the 12 months after the contribution. Treas. Reg. § 1.362-2(b)(1977).

103. Edwards v. Cuba R.Co., 268 U.S. 628, 632 (1925). *See* Madison Fund Inc. v. Comm'r, 365 F.2d 471 (3d Cir. 1966) (settlements from suit for mishandling taxpayers investments, which were treated as nontaxable recoveries of capital, reduced taxpayer's basis in the stock sold); 379 Madison Ave., Inc. v. Comm'r, 23 B.T.A. 29, 41-42 (1931)(depreciable basis reduced by reimbursements), *rev'd on another issue*, 60 F.2d 68 (2d Cir. 1932); Treas. Reg. § 1.165-1(d)(2)(1977)(losses reduced by amounts for which there exists a reasonable prospect of reimbursement); Rev. Rul. 81-152, 1981-1 C.B. 433 (recovery against builder of condominium for defect in construction reduced homeowners' basis). *Cf.* I.R.C. § 1016(a) (providing that "proper adjustment in respect of the property shall in all cases be made—(1) for . . . receipts . . . properly chargeable to capital account . . . .").

In United States v. Chicago, B.& Q.R. Co., 412 U.S. 401, 407 (1973), the Court described *Cuba R.Co.* as responsible for the anomalous result that the corporation could receive propthe "mere custodian" and the "reimbursement" rationales generate both a tax exemption for the receipt of the property and subsequent zero basis to the corporation. A fair market value basis, accordingly, is not a necessary implication of the exemption for the receipt by the corporation.

Issuance of stock, "wherein the corporation acquired its invested capital,"[104] as Kohl puts it, also commonly gives the corporation property with a carryover of the contributor's basis. Section 351 gives nonrecognition treatment to both shareholder and corporation when the shareholder transfers appreciated property in exchange for stock, provided the transferors of property control the corporation after the exchange.[105] But section 362(a) then provides that the corporation has only a carryover of the shareholder's basis in the appreciated property the shareholders have transferred and not a step up to a new fair market value basis. The premise for the section 351 nonrecognition is that the transaction "works a change of form only."[106]

> It is the purpose of [section 351] to save the taxpayer from an immediate recognition of gain . . . in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really "cashed in" on the theoretical gain, or closed out a losing venture.[107]

The theory that the transaction is a mere change in form also implies that the basis of the assets should not change. "The assets of the new corporation should be the same as the basis of those assets in the hands of the [shareholders] prior to the exchange."[108] Many—perhaps most—acquisitions with stock under section 1032 "by which the corporation acquired its capital" have a mandatory carryover basis under section 362 because they are also described

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erty tax free and also be "allowed to assert a deduction for depreciation on the asset so received tax free." That result was not inherent in the original *Cuba R.Co.*. language, which describes a "reimbursement" rationale, although the result describes Brown Shoe Co. v. Comm'r, 339 U.S. 583 (1950), which was attempting to interpret *Cuba R.Co.*.

104. Kohl, *supra* note 40, at 643.

105. Control is defined by I.R.C. § 368(c) to mean 80% of the voting stock of the corporation.

106. B. BITTKER & J. EUSTICE, *supra* note 5, at ¶ 3.01.

107. Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir., *cert. denied*, 310 U.S. 650 (1940). *Accord*, Rev. Rul 73-472, 1973-2 C.B. 115 (basic premise of I.R.C. § 351 is that transfers to controlled corporations work only changes in form).

108. Statement of the Changes Made in the Revenue Act of 1921, *supra* note 65 and quoted in accompanying text.

by section 351 of the Code.[109] In sum, the exemption provided for the corporation by section 1032 for receipts of its capital cannot be used to imply a fair market value basis for the corporation under a Code that commonly and properly gives the corporation a zero or carryover basis instead.

Even beyond the question whether section 1032 implies a fair market value basis, it is difficult to see why a permanent exemption for capital is merited under tax policy or doctrinal arguments. Kohl argues that an initial value basis is implied by the nature of the transaction as a transaction "whereby a corporation acquired its invested capital."[110] That argument depends upon quite archaic notions of "capital." As noted,[111] under a normal income tax, capital generating an investment return must be reduced by tax if the system is going to identify and tax the true income from the capital; failure to tax capital gives an investment a benefit within an income tax that is usually as advantageous as a an explicit exemption from tax for the income. To identify something as capital is now, as a matter of tax policy, a better reason for taxing it than for giving it a permanent tax exemption.

The argument that the fair market value of "capital" must be given a permanent exemption from tax has also been explicitly rejected by the courts, at least as a constitutional matter. In a number of cases, for instance, corporate taxpayers challenged the con-

109. It is also arguable from the face of the statute that the 1954 drafters of section 1032 thought that in *all* section 1032 transactions the corporation would carry over the shareholder's basis, increased by shareholder gain recognized in the transaction. The only basis reference within section 1032 itself, subsection (d), is to the section 362(a) carryover provisions. Commentators other than Kohl have treated a carryover basis as the grand design of section 1032 acquisitions, even in transactions wholly taxable to the shareholders. See Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps*, 63 Tex. L. Rev. 89, 126-127 (1984); Kirkpatrick, *Tax Consequences of a Corporation Dealing in its Own Stock*, 13 Tul. Tax Inst. 85, 97 (1964).) Thus, as discussed in the next part, section 1032 might be entirely a carryover basis section.

It is also plausible from the context of the statute that the 1954 drafters thought that section 1032 gave only a temporary or transaction exemption from tax, rather than a forgiveness of tax that would last forever. Section 1032 provides for "nonrecognition" of gain, rather than for "tax exemption" for income, and "nonrecognition" usually implies mere deferral of tax. For the "nonrecognition" sections that are the neighbors of section 1032 in the Code, there is an adjustment of basis to prevent untaxed appreciation from disappearing. *See, e.g.*, I.R.C. §§ 1031(d), 1034(d). The permanent exclusions of I.R.C. §§ 101-134 are in Subchapter B, Computation of Taxable Income, and the nonrecognition provisions of I.R.C. §§ 1031-1042 are in Subchapter O.

110. Kohl, *supra* note 40, at 643.

111. See *supra* text accompanying note 88.

stitutionality of the section 362(a) carryover basis on the ground that the fair market value of the property when contributed was its capital that could not be taxed even on sale.[112] The courts uniformly upheld the carryover basis scheme and rejected the step up.[113] Consistently, in *Taft v. Bowers*,[114] the taxpayer challenged the constitutionality of the section 1015 carryover basis for gifts, arguing that the value of the gift at the time of receipt was "capital in the hands of the donee."[115] The Supreme Court responded that "[t]here was only a single *investment* of capital—that made by the donor,"[116] and upheld the constitutionality of requiring the donee to take over the donor's basis. Once basis comes to refer to an *investment* by some taxpayer, rather than the value of the property when received by the taxpayer, Kohl's argument that the corporation must have a fair market value basis has little continuing appeal.

D. *THE CARRYOVER BASIS THEORY*

A fair market value basis for property acquired with the corporation's own stock could be explained under a theory that the corporation is just carrying over the basis of the seller who receives the stock.[117] The seller of the property, receiving stock in a transaction that does not qualify either as a reorganization or as a taxfree incorporation under section 351, has a taxable transaction. Section 1032, providing nonrecognition for the corporation issuing the stock, protects only the corporation. The seller, who at least becomes a shareholder as a result of the exchange, ordinarily gets

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112. *See, e.g.*, T.W. Phillips, Jr., Inc. v. Comm'r, 63 F.2d 101, 102-103 (3d Cir. 1933), quoted in text accompanying *supra* note 56.

113. T.W. Phillips, Jr., Inc. v. Comm'r, 63 F.2d 101, 102-103 (3d Cir. 1933); Newman Saunders & Co., Inc. v. United States, 36 F.2d 1009, 1010-11 (Ct. Cl. 1929), *cert. denied* 281 U.S. 760 (1930); Osburn California Corp. v. Welch, 39 F.2d 41 (9th Cir. 1930), *cert. denied* 282 U.S. 850 (1930); Schweitzer & Conrad, Inc. v. Comm'r, 41 B.T.A. 533, 545 (1940).

See also the discussion of the "initial value" or "capital" basis in text accompanying notes 36-88.

Kohl's explanation of section 1032 generalizes from the model of section 1014, giving a step up in basis at death (see *supra* note 94 and accompanying text), but in a comprehensive tax system that attempts to spread the tax burden across all economic gains, section 1014 is an anomaly, arising from a now rejected norm, that should be contained within its borders.

114. 278 U.S. 470 (1929).

115. *Id.* at 471.

116. *Id.* at 482 (emphasis added).

117. A carryover basis theory was used as a justification for the corporation's basis in Bryan, *supra* note 109, and Kirkpatrick, *supra* note 109.

basis for the cumulative amounts she has paid tax on and thus should increase basis by the gain (or decreases basis for the loss) recognized in the exchange.[118] Once the basis of the seller-shareholder is increased by gain the seller-shareholder recognizes on receipt of the stock, the basis of the seller-shareholder equals the fair market value of the stock when received.[119] If the corporation can get credit for the selling shareholder's cumulative basis, then it will have a basis equal the fair market value of its stock—even if we reject the theories that the corporation has basis on its own from the value it has given up or from the value of the property when received.[120]

Under current tax law, however, a corporation is not allowed to use the basis of a noncontrolling shareholder who sells property to the corporation for stock. The case law result, at least as it developed when the law thought that the corporation was entitled to a value-given-up or initial value basis, is clearly that no carryover basis is allowed (or required) in a taxable sale. Absent specific statutory authorization, a corporation cannot establish its basis by reference to some other taxpayer, but gets basis only from its own cost or capital investment.[121] The current regulations governing section 1032 acquisitions provide, with support by a host of cases, that if the acquisition is not a reorganization and not covered by section 351 or some other nonrecognition provision, then the cor-

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118. I.R.C. §§ 358(a)(1)(B)(ii) (shareholder's basis is increased by gain recognized). The increase in basis, to reflect cumulative amounts the taxpayer has paid tax on, is within the primary function of basis to prevent taxation of amounts previously taxed. See discussion, *supra* note 30 and accompanying text.

119. The amount realized by the shareholder must be equal to the shareholder's old basis plus gain recognized: Since gain is the amount realized less basis (I.R.C. § 1001), elementary mathematics shows that the amount realized must be equal to the old basis plus gain. Old basis plus gain sets the shareholder's final basis.

120. A carryover basis theory yields a corporate basis equal to the value of its stock, rather than the value of the property received—assuming again that there can be a disparity between the value of stock and the assets exchanged for it. See *supra* note 39-40 and accompanying text. Looking to the initial value of the assets received by the corporation (*see e.g.*, Kohl, *supra* note 40, discussed in text accompanying *supra* notes 40 & 95-96) would be a violation of both the cost theory and the carryover theory of basis.

121. *See, e.g.*, Unaka & City National Bank v. United States, 50 F.2d 1031 (6th Cir. 1931), discussed in text accompanying *supra* note 58, where the court, over a vigorous dissent, refused to allow the surviving corporation in a tax-free merger to carry over the $51,260 tax basis of the disappearing corporation that transferred the assets in the merger and required the corporation to use the $38,500 value of the stock it issued instead. *See also* cases cited, *supra* notes 41 and 43, giving the corporation a tax-free step in basis rather than applying a carryover basis from shareholder. *See, e.g.*, F. PEARCE, INCOME TAX FUNDAMENTALS 346-358 (1937) (objecting to carryover basis as a retroactive "limitation of basis" in a reorganization effected before 1924 when Congress expressly provided for carryover).

poration's basis shall be its cost.[122]

As a matter of tax doctrine, the question whether a corporation gets a carryover basis is tied to the question whether the transaction is a nonrecognition event to the seller. Acquisitions with stock are treated either as mere change of form transactions in which basis carries over from the shareholder or as purchases by the corporation in which the corporation's basis is determined by the amount of its own expenditure. The two characterizations are mutually exclusive.[123] A transfer of property in a reorganization or tax-free incorporation is considered to be a mere change in the form of the shareholder's investment,[124] and by the same theory, the transaction does not change the tax basis of the asset transferred.[125] But if the acquisition fails as a reorganization, even for some silly technical reason, the acquisition is treated as a normal purchase and the corporation is treated as having made an expenditure with its stock.[126] The seller of the property becomes just like a normal seller who has truly disposed of the transferred property and has no "continuity of interest" with the property given up.[127] Symmetrically, the acquiring corporation has no continuing relationship—and no carryover basis—from the seller disposing of the

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122. Treas. Reg. § 1.1032-1(d) (1960) ("For the basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualifiy under any other nonrecognition provision, see section 1012 [providing that basis shall be cost unless otherwise provided]."). See cases cited *supra* notes 13-18 and accompanying text.

123. *Cf.*, ACCOUNTING PRINCIPLES BOARD, OPINION NO. 16, BUSINESS COMBINATIONS ¶ 43 (1970) (pooling of interest accounting and purchase accounting are not alternatives in accounting for the same business combination).

124. Treas. Reg. § 1.368-1(b) (1985) (reorganizations); Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir. 1940), *cert. denied*, 310 U.S. 650 (1940) (quoted in text *supra* note 107) (purpose of section 351 is prevent taxation of mere changes in form); Rev. Rul 73-472, 1973-2 C.B. 115 (basic premise of I.R.C. § 351 is that transfers to controlled corporations work only changes in form).

125. Statement of the Changes Made in the Revenue Act of 1921 by H.R. 6715 and the Reasons Therefor, *supra* note 65.

126. *See, e.g.*, McDonald's Restaurants of Ill. v. Comm'r, 688 F.2d 520 (7th Cir. 1982) (acquirer gets fair market value basis for assets acquired in merger because target shareholders intent to sell acquirer's stock violated continuity of interest requirement); Rev. Rul. 56-100, 1956-1 C.B. 625 (*accord*) and authorities cited *supra* note 124.

127. Treas. Reg. § 1.368-2(a) (1985) codifying, *e.g.*, Cortland Specialty Co. v. Comm'r, 60 F.2d 937, 939-40 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933) (corporation's exchange of assets for cash and acquirer's short-term notes was a sale and not a reorganization); Camp Wolters Enterprises, Inc. v. Comm'r, 22 T.C. 737, 751 (1954), *aff'd*, 230 F.2d 555 (5th Cir. 1956) (nontaxable securities (before 1989 amendment of section 351) must represent continuing interest, not cash out). *See generally* B. BITTKER & J. EUSTICE, *supra* note 5, ¶ 3.04 (section 351) ¶ 14.11 (reorganizations) (The "continuing interest" doctrine, in its many variations, is intended to prevent transactions that are really disguised sales from qualifying as nontaxable transactions.)

property.

Basis also carries over from a gratuitous donor to a donee.[128] But a seller for stock is not a donor to the corporation because the stock received in return for the property means that the transfer was not an act of detached and disinterested generosity.[129] In real gifts the donee's consumption is considered to be just a variety of consumption by the donor.[130] A corporation buying property from an independent seller, however, is not continuing the seller's own consumption of the transferred property. The corporation, in sum, has no privity with a noncontrolling shareholder.

The seller of the property for stock is a stranger to the corporation as a matter of law. Strangers do not transfer their post-tax position, *i.e.*, basis, to other strangers. Under section 362(c), if a nonshareholder (or shareholder not acting as such) contributes property to a corporation, the nonshareholder's basis does not become part of the corporation's basis.[131] The corporation has zero basis in property contributed by the nonshareholder and cash contributed by the nonshareholder reduces the corporation's basis in some asset.[132] The zero basis rule is a compelling rule for property sold for stock by noncontrolling shareholders; both the nonshareholder (or shareholder not acting as such) and the seller, who incidentally becomes a noncontrolling shareholder in the exchange of property for stock, are strangers without tax privity with the corporation.

The zero basis rule for contributions from nonshareholders is now codified in section 362(c), but the rule has a logic beyond the legislative fiat. As noted previously, when a nonshareholder incurs a cost for its own good or the good of the public or community, that cost is not part of the corporation's investment or cost in any asset.[133] The corporation gets no basis from an investment it did

128. I.R.C. § 1015.

129. Commissioner v. Rosenbloom Finance Corp., 66 F.2d 556 (3d Cir.), *cert. denied*, 290 U.S. 692 (1933). *See* Commissioner v. Duberstein, 363 U.S. 278, 285 (1960) ("detached and disinterested generosity" required for a gift).

130. *See, e.g.*, DEP'T OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 36-38 (1977). Since a gift is a continuation of the donor's consumption, there should not be an extra tax just because the donor consumes property in one form rather than another.

131. I.R.C. § 362(c). The corporation's receipt of the contribution is tax free. I.R.C. § 118.

132. Treas. Reg. § 1.362-2(a) (1977). Cash subsidies not earmarked or identified with specific property reduce the corporation's basis under a set of automatic rules that usually first reduce the taxpayers basis in all depreciable properties acquired in the 12 months after the contribution. Treas. Reg. § 1.362-2(b) (1977).

133. See *supra* note 103, citing United States v. Chicago, B.& Q. R. Co., 412 U.S. 401

not make and that the nonshareholder made to benefit somebody else.

The zero basis rule is also supported by the rationale that a stranger's costs are a reimbursement of the corporation's capital expenditures. In 1925, the Supreme Court, in *Edwards v. Cuba Railroad*,[134] held that a cash subsidies by the Cuban government to construct a railroad across Cuba were not "profits or gain from the use or operation of the railroad" to the railroad corporation that received the subsidy, so that the subsidy was not "income" that could be taxed constitutionally under the authority of the 16th amendment.[135] The subsidy was not profit, the Court said, because the Cuban government payment was a reimbursement:

> Relying on the contract for partial reimbursement, [the taxpayer corporation] found the money necessary to construct the railroad. The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse [the taxpayer corporation] for capital expenditures.[136]

The Court did not have before it the question of what basis resulted to the Cuba Railroad Company from the subsidies, but the reimbursement of capital expenditures rationale logically implies that the corporation should reduce its basis in railroad property by the amount of the cash reimbursement.[137] *Edwards v. Cuba RR* is best understood as a recovery of capital case.[138]

(1973) (railroad has zero basis in assets given to it by various governments, prior to enactment of section 362(c), because governments gave or constructed underpasses, crossings, and other facilities for the safety and benefit of the general public and not for the private welfare of the railroad).

134. 268 U.S. 628 (1925).

135. 268 U.S. at 633. Current constitutional jurisprudence allows considerably more room, within the 16th amendment, for Congress to define taxable income broadly. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (unearned windfalls may be taxed because they are undeniable accessions to wealth; "earnings" are not constitutionally required).

136. 268 U.S. at 632.

137. *See, e.g.*, Madison Fund Inc. v. Comm'r, 365 F.2d 471 (3d Cir. 1966) (settlements from suit for mishandling taxpayers investments, which were treated as nontaxable recoveries of capital, reduced taxpayer's basis in the stock sold); 379 Madison Ave., Inc. v. Comm'r, 23 B.T.A. 29, 41-42 (1932) (depreciable basis reduced by reimbursements), *rev'd on another issue*, 60 F.2d 68 (2d Cir. 1932); Treas. Reg. § 1.165-1(d)(2) (1977) (losses reduced by amounts for which there exists a reasonable prospect of reimbursement); Rev. Rul. 81-152, 1981-1 C.B. 433 (recovery against builder of condominium for defect in construction reduced homeowners' basis).

138. In United States v. Chicago, B & Q R. Co., 412 U.S. 401, 407 (1973), the Court described *Cuba R. Co.* as responsible for the anomalous result that the corporation could receive property tax free and also be "allowed to assert a deduction for depreciation on the asset so received tax free." That result was not inherent in the original *Cuba R. Co.* lan-

Consistently, in 1943 the Supreme Court in *Detroit Edison Co. v. Commissioner*[139] held that cash subsidies from customers were not part of the taxpayer's cost nor basis. The taxpayer in the case was an electrical utility that would extend electrical lines to farmers and other remote customers only if the customer paid part of the costs of extending the lines and extra equipment needed. The customer's payments for the lines were not income to the utility, "presumably," the Court said, "because it has been thought precluded by this Court's decision in Edwards v. Cuba R. Co."[140] but the Court required the utility to reduce its basis in the lines and equipment by the amount of the customer's cash payments. The Court said that the utility need not be allowed depreciation on an "investment it refused to make"[141] and that the adjustment was needed to reach the utility's "net investment."[142] The rationale of *Cuba RR* and *Detroit Edison,* denying a corporation basis from transferors who are nonshareholders, is broad enough to cover transfers from sellers who incidentally acquire noncontrolling stock.[143]

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guage, although it describes Brown Shoe Co. v. Comm'r, 339 U.S. 583 (1950) discussed in text accompanying *infra* note 143.

The Cuban government also gave the Cuba Rail Corporation land and other physical properties to aid completion of the railroad (268 U.S. at 632), but the properties were not treated as income by either the Service or the Court. Consistent with the text's reading of the decision as to cash subsidies, the railroad should have had no basis in the physical properties, as if the railroad never really owned the properties.

139. 319 U.S. 98 (1943).

140. *Id.* at 103.

141. *Id.*

142. *Id.* Stated in double entry bookkeeping terms, the issue in *Detroit Edison* was, what was the credit entry from the transaction? When the taxpayer received the cash from customers, there was a debit entry (increase) for the cash. The credit entry could not be to income, under the assumption that *Cuba R. Co.* precluded treating the cash as income. But was the credit entry straight to shareholder's equity, in which case the taxpayer would keep his asset (basis) or was the credit entry a contra-asset account? The Court's resolution was that the credit entry was a contra-asset account, reducing basis in the property purchased with the cash. To treat the credit entry as a straight increase in shareholder's equity, would have been to allow an untaxed increase in the taxpayer's net worth, and in a comprehensive tax system, untaxed increases in net worth should be rare. Treating the cash as a reimbursement of costs makes the *Cuba R. Co.* exemption seem less of an anomaly within a comprehensive tax system.

143. The rule proposed in the text is valid notwithstanding the contrary holding in Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950). In *Brown Shoe*, the court allowed a shoe manufacturer to get basis from subsidies that various community groups (from 12 separate towns throughout the Midwest) paid to induce the manufacturer to locate or expand its shoe factories in their communities. The Court held that communities had made a "contribution to the capital" of the manufacturer—rather than a reimbursement that was a "recovery of capital" to the manufacturer—and it gave the corporation a carryover basis, equal

to the cost of the properties (and cash) to the community groups that made the contributions. Since the purpose of the subsidies was so closely tied to the building or improving of a factory, a more natural accounting for the transactions would have been to reduce the cost of the factory asset on the taxpayer's books.

The Court claimed that the subsidies fit within the predecessor of section 362(a)(2), providing a carryover basis for a paid in surplus or contribution to capital (339 U.S. at 590), but that finding does not now seem necessary. Section 362(a)(2) had been enacted to reverse the step up in basis the Board of Tax Appeals gave in Rosenbloom Finance Corp v. Comm'r, 24 B.T.A 763 (1931), *rev'd*, 66 F.2d 556 (3d Cir.), *cert. denied*, 290 U.S. 692 (1933), where a shareholder made a contribution to his family corporation without taking back stock. Congress in enacting the predecessor of section 362(a)(2) was thinking of *Rosenbloom*-like contributions by majority shareholders who have privity with the corporation and who can get their return only by augmentation of the stock. (There is, however, nothing on the face of the predecessor to section 362(a)(2) limiting the basis carryover to contributions from *shareholders*, at least prior to the enactment of section 362(c) in 1954).

The Court in *Brown Shoe* had to distinguish its subsidies from communities wanting a factory from the *Detroit Edison* subsidies from farmers wanting electrical lines—which is a difficult distinction to maintain. *See, e.g.*, United States v. Chicago, B.& Q. R. Co., 412 U.S. 401, 412 (1973) and commentators there cited, to the effect that *Detroit Edison* and *Brown Shoe* are irreconcilable. But *Detroit Edison* had avoided the predecessor of section 362(a)(2) (giving a carryover basis for "contributions to capital"), somewhat awkwardly, by arguing that the farmers and other customers who furnished the subsidies intended neither donations nor "contributions" to the utility. "The payments were to the customer," the Court had said in *Detroit Edison*, "the price of the [electrical] service." 319 U.S. at 103 In *Brown Shoe* the Court took advantage of the awkward distinction that *Detroit Edison* had used to in turn distinguish *Detroit Edison*, saying that in *Detroit Edison*, "there are neither customers nor payments for service," 339 U.S. at 591.

The distinction is untenable. The farmers in *Detroit Edison*, contributing to construction of the lines, were not paying for past services; they would be charged separately for future electricity; and they would get no refund of their costs if they took little or no future electricity. If the payments in *Detroit Edison* had been viewed as in consideration for services, the payments would have been normal taxable income from operations to the utility (credit entry to income), rather than reimbursements of investments, and even *Cuba R. Co.* would have allowed their taxability. *See, e.g.*, Lykes Bros. S.S. Co. v. Comm'r, 126 F.2d 725 (5th Cir. 1942) (subsidies were payments for services and therefore distinguishable from *Cuba R. Co.* and taxed)). The rationale of *Detroit Edison*, that taxpayer's investment excludes costs borne or reimbursed by outsiders for their own interests and reasons, in truth covers both the subsidies from the farmers and from the communities.

The basis result in *Brown Shoe*, in any event, is no longer good law. It was reversed by Congress by specific reference in 1954 by the enactment of section 362(c), which now requires a corporation to take a zero basis in property supplied by a nonshareholder and to reduce the corporation's basis in purchased assets by cash reimbursements contributed by a nonshareholder or by a shareholder not acting as such. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 272 (1954).

Even as to years before the effective date of the 1954 statutory reversal, *Brown Shoe* was so limited as to be tantamount to reversal, by the Supreme Court's decision in United States v. Chicago, B.& Q. R. Co., 412 U.S. 401 (1973). *Chicago, Burlington* denied a railroad corporation basis, notwithstanding the carryover of basis for contributions to the capital of a corporation, for state-funded railroad underpasses and overcrossings, bridges, and crossing signs that the railroad was given and then required to maintain. The state funding of railroad assets is of course indistinguishable in good principle from community groups' funding receiving stock in a taxable sale is also consistent with our rules for shareholders receiving debt. When a corporation buys appreciated property from a shareholder with an installment obligation, the corporation commonly wants to avoid a carryover basis. Within a number of important constraints, a shareholder selling appreciated property in exchange for her corporation's installment obligations may avoid paying tax on the principal amount of the obligations until the principal payments are actually paid.[144] The corporation by contrast is entitled to treat the unpaid principal of the obligations as its basis immediately and it can use the higher basis by sale or depreciation of the property.[145] The immediate basis for the corporation, combined with deferred gain for the shareholder will give the parties together a tax float under which tax is saved on one side before, possibly long before, tax is paid on the other.[146] Since 1980 there have been important statutory restrictions cutting back on tax floats between corporations and shareholders, but they do not affect sales by minority shareholders.[147] Establishing a new

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of shoe factories and, for that matter, from customer funding of electrical lines. The Court denied that the state-funded railroad underpasses were contributions to the capital of the railroad (and part of the railroad's depreciable basis) because the assets were provided primarily for the safety and benefit of the public, rather than primarily for the benefit of the railroad. That rationale, of course, covers *Brown Shoe* as well, because the community groups paying for the factory locations were intending to benefit the public in their communities, rather than the shoe company. After a detour in *Brown Shoe*, in any event, it is now settled that costs borne by outsiders give the corporation no basis. Treating noncontrolling shareholder payments as reimbursement reducing basis, as in *Detroit Edison*, is an attractive way to describe the transactions.

144. I.R.C. § 453. Installment sales are not available, for instance, for property held for sale to customers in the ordinary course of the taxpayer's trade or business (I.R.C. § 453(b)(2), 453(*l*)(1)) with exceptions for certain farm property and, if the taxpayer pays an interest charge, for residential property (I.R.C. § 453(l)(2)). Corporate obligations that are payable upon demand or that are readily tradeable constitute payments that are immediately taxed. I.R.C. § 453(f)(4). Pledging an installment note also constitutes a payment. I.R.C. § 453A(d). If a taxpayer holds more than $5,000,000 in installment sales (with a number of exceptions), the taxpayer pays interest on tax deferred beyond sale. I.R.C. § 453A(b).

145. *See, e.g.*, Crane v. Comm'r, 331 U.S. 1 (1947) (basis includes purchase money debt).

146. *See* Johnson, *Current & Quotable: A New Way to Look at the Tax Shelter Problem*, 23 TAX NOTES 765 (1984) (explaining "tax floats").

147. If the seller-shareholders directly or indirectly own 50% of the purchasing corporation, then a disposition of the property by the corporation within 2 years will constitute a "payment" that will end the shareholders' installment sale deferral. I.R.C. § 453(e) & (f)(1)(B) by reference to § 267(b)(2). If the property sold to the 50% corporation is marketable securities, then the 2-year cut off period is extended as long as the installment obligations are outstanding. For depreciable property, moreover, there will also be no increase in the depreciable basis of a 50% controlled corporation prior to shareholder gain, unless the parties satisfy the Service that tax avoidance was not one of the principal purposes of the

principle that basis carries over from minority shareholders on property transferred by them would upset established, fairly routine tax planning. If a corporation does not have to take a carryover basis from a minority or noncontrolling shareholder when it is unfavorable to the corporation, it is difficult to see how it is entitled to take a carryover basis when the carryover would be favorable.[148]

A possible final argument is that the courts should adopt a carryover basis as a bit of homemade corporate integration to cure the double tax on corporate income. If a corporation gets no basis in property acquired for stock, it will pay tax on the gross income the property generates, even though the seller, a noncontrolling shareholder, has already paid tax on the profit. Assume, for instance, that taxpayer *A* buys property, Blackacre, for \$40x of salary and that after Blackacre appreciates, *A* sells Blackacre to a noncontrolled corporation, *B Corp.*, for \$100x of *B Corp.* stock. *A*

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transaction. I.R.C. § 453(g) by reference to I.R.C. § 1239(b). The scope of I.R.C. § 453(g) was expanded from sales to corporations 80% or more owned by the sellers to corporations more than 50% owned by the sellers by the 1986 Tax Reform Act. Pub. L. No. 99-514, § 642(c), 100 Stat. 2085, 2284, amending I.R.C. § 1239(c). None of the restrictions, however, affect a tax float if sellers own less than 50% of the corporation (directly or indirectly) even after the receipt of stock for their property.

Prior to 1989 a shareholder could defer tax for corporate debt qualifying as a "security" received in a section 351 transaction but the corporation would then have only a carryover basis in the property it receives. *See, e.g.*, Nye v. Comm'r, 50 T.C 203 (1968) (10-year notes were securities, although they were not disguised equity). The Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7203, 103 Stat. 2106, 2333, amended section 351 to provide that debt securities were boot taxable immediately to the shareholder unless they qualified under section 453. The 1980 Installment Sale Act had previously provided that section 453 was a gain nonrecognition provision, so that the corporation receiving property in a section 351 exchange could not get a step up under section 362 before the shareholder recognized gain. Roche, *Dispositions of Installment Obligations*, 41 TAX L. REV. 7 n. 28 (1985).

148. Bryan, *supra* note 109, explicitly argues for a carryover basis theory in critiquing I.R.C. § 108(e)(10) (requiring forgiveness of indebtedness income upon a corporation's swap of its stock for its debt). She argues that if the holder of the debt has a tax-free capitalization—a nonrecognition treatment given for reasons that have no bearing on the treatment of the corporation—the corporation should have income recognition only to the extent the debt exceeds the basis of the debt-holder who becomes a new shareholder in the swap of stock for debt. This Article supports I.R.C. § 108(e)(10), which in fact requires forgiveness-of-indebtedness income recognition to the extent the debt forgiven by the swap exceeds the fair market value of the stock, and rejects Professor Bryan's critique of it. This Article argues that that the basis of the debt-holder, who becomes a minority shareholder by reason of the swap, is not germane to the accounting for the income of the corporation. The costs and accounts of a stranger have no bearing on the corporation's income. The carryover basis theory, however, is applicable to partnerships. See *infra* notes 217 & 218 and accompanying text.

must recognize $60x gain on the transaction. Between the post-tax cash of $40x put into Blackacre and the $60x gain recognized on the sale, *A* has paid tax on $100x. But if *B Corp.* has zero basis for Blackacre, then *B Corp.* too will pay tax on $100x if *B Corp.* sells Blackacre for $100x. If Blackacre is a depreciable asset consumed in generating *B Corp.*'s revenue, *B Corp.* will pay tax on the full revenue Blackacre generates for *B Corp.* The tax *B Corp.* pays is a double tax because *A* already paid the tax on the gain in Blackacre.

But carryover basis can not be supported on the rationale that it avoids the double tax because, whatever the ultimate policy, the corporate tax is in fact pervasively a double tax system. If *A* is viewed as an outsider not in privity with *B Corp.*, then the tax *A* pays is no defense for *B Corp.* The farmers subsidizing electrical lines in *Detroit Edison* paid tax on the cash they transferred to the corporation. The corporations, however, got no basis for outsider costs. Cash is taxed every time it changes hands in payment for goods and services and it can be no defense for a taxpayer to argue that property or cash received has previously been taxed to some other taxpayer. Double tax is not objectionable if there are two separate parties bearing each tax and not some single economic unit. Noncontrolling shareholders are not considered to be in the same economic unit as the corporation.

Double taxation of corporate income, moreover, is too ingrained in the tax system to be fixed, in small pieces on an ad hoc basis. Double tax, for instance, is built into the statutory system for exchanges of stock for property governed by section 351 transfers. If shareholder *C* transfers Redacre, worth $100x and having a basis of $40x to her wholly owned corporation, *D Corp.*, in exchange for stock, the exchange will be tax free under section 351 and both *C* and *D Corp.* will derive their basis from the same $40x basis that *C* had in Redacre before the exchange.[149] The replication of the $40x basis on both the shareholder and corporation level means that there will be two levels of gain where before there was only one—*C*'s gain. *D Corp.* will have $40x basis for Redacre and will thus have $60x gain on selling Redacre for its current $100x value. *C* will have stock that will increase in value by the $100x value of Redacre (less the value of the tax that *D Corp.* will pay), but *C* will have only an extra $40x basis for that stock. Thus *C* will also have gain, measured from the low $40x basis, even though *D*

149. I.R.C. §§ 358(a) (shareholder basis); 362(a) (corporate basis).

Corp. paid tax on the gain. The double taxation will not be limited, moreover, to just pre-contribution appreciation on Redacre. Any revenue or further gain that Redacre produces after the contribution will also be subject to double tax. Under a general double level corporate tax scheme, taxes paid by the corporation do not protect the shareholders from tax. If the statute imposes double tax on appreciation coming from controlling shareholders, in certain circumstances, then there is even less reason for judicial tax doctrine to relieve double tax on appreciation coming from noncontrolling shareholders. A shareholder and controlled corporation by contrast are plausibly a single economic unit, considered separate only by juridical fiction.

A carryover basis from noncontrolling shareholders selling for corporate stock, in sum, can not be reached by judicial doctrine or policy under current law.

E. *CIRCLE OF CASH*

Another theory suggested to justify the corporation's basis is that the corporation can achieve a fair market value basis anyway by self-help using cash. A corporation can issue its own stock for cash and then use the cash to acquire the property. Since cash always carries its own basis,[150] if the corporation can acquire the cash tax free by selling stock, it can achieve basis in some asset. Thus, it is argued, the corporation must be given a fair market value basis for property acquired with stock to be consistent with the rules for cash acquired with stock and with the results the corporation could reach anyway.[151] This part argues that the circle of

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150. *See, e.g.*, B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 547 (5th ed. 1980) ("Cash always has basis equal to its monetary amount. Any other system would be an administrative impossibility.").

151. Hudson Motor Car Co. v. United States, 3 F. Supp. 834, 846 (Ct. Cl. 1933) (compensation paid with stock yields a deduction because deduction would have been allowed if compensation had been paid in cash and cash had been used to buy stock); Duncan Industries, Inc. v. Comm'r, 73 T.C. 266, 283-84 (1979)(stock provides amortizable expense because corporation could have sold stock for cash and used cash to pay the expense); I.T. 2041, III-1 C.B. 392, 393 (1918) (compensation deduction allowed because stock could have been sold for cash); Treas. Reg. § 1.83-6(d)(1) (1978) (subsidiary's use of parent stock considered to be first a contribution to the capital of the subsidiary, then a purchase of the stock, and then use of the stock by the subsidiary). *Cf.* Luckman v. Comm'r, 418 F.2d 381, 384 (7th Cir. 1969) (qualified stock option reduces earnings and profits because it had same effect as cash compensation followed by employee purchase of stock). *See* Banoff, *The Zero Basis Dilemma in Nonqualifying Triangular Acquisitions*, 41 U. CHI. L. REV. 92, 102, 109 (1973) (arguing against treating a subsidiary as having a zero basis in parent stock because the subsidiary could purchase parent stock with cash contributed by the parent); Walter, *The*

cash argument begs the question. While the rules for property and cash should be consistent, consistency between cash and property acquired with stock could be achieved by treating cash received from selling stock to noncontrolling shareholders as a reimbursement of the corporation's costs, which reduce corporate basis in some asset. The possibility of bringing the treatment of cash sales into line with a zero basis for the corporation means that the current treatment of cash sales of stock does not legitimate a corporate fair market value basis.

Under current law, cash acquired by sale of stock can give the corporation a fair market value basis in property. If there were a rule that a corporation could get only a zero basis or low carryover basis for property acquired with stock, then corporations would avoid the rule by selling their stock for cash instead. Suppose, for instance, property with a basis of $40 in the seller's hands is worth $100 and that the corporation faces a new tax rule providing that using stock to acquire the property directly gives the corporation a zero or $40 basis. The corporation could avoid the rule and achieve the $100 basis by selling its own stock for cash of $100 and then using the $100 cash to buy the property. The seller of the property would pay tax on the $60 gain, but that is the result whether the sale was for cash or in exchange for the stock. The issuing corporation pays no tax whether the stock is exchanged for cash or for property. If the seller insisted on owning stock of the acquiring corporation, she could buy the stock in a separate transaction with her $100 cash proceeds from the sale of the property. Alternatively, the parties could reverse the order of the steps and have the corporation acquire the property for $100 cash and then get its cash back by selling its stock for $100. Either way, the cash can go back in a circle back to the original party. The cash is needed in the transaction only for a short while to carry basis to the property. After a circle of cash, going in either direction, both corporation and seller would end up with property with a $100 basis.

Under the step transaction doctrine, sales of stock for cash might sometimes be treated as in substance a purchase of property with the stock. The step transaction doctrine provides that purportedly separate intermediate steps may be ignored if they are in

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Issuer's Own Stock—Section 1032, Section 304 and Beyond, 68 TAXES 906 (1990) (corporation allowed to write up basis, just as if the issuer had sold the stock for cash and used the cash to buy the property).

substance part of a single unified transactions.[152] Thus some sales of stock for cash followed quickly by a use of the cash to acquire property might be considered to be in substance direct acquisitions of property for stock.

But there are limits beyond which the step transaction doctrine can not reach. At some point, steps separated by enough time or justified by business purposes can avoid being collapsed. A corporation could just use cash to acquire the property and then replenish its cash supply when needed after a substantial delay by issuing more stock for cash. It could also sell stock for cash, long before it is needed for any specific acquisition. A corporation without much sacrifice could ordinarily plan for long intervals between stock issuance for cash and the property acquisition. As long as cash can be acquired tax free and cash has its own basis that can be transferred to the property it is used to purchase, then corporations can achieve a fair market value basis for the property with proper tax planning.

If the parties can arrange for a fair market value basis with planning, then some lesser basis becomes a trap only for the unwary who do not plan correctly. If the $100 basis, in the prior example, can be accomplished by what might be cumbersome steps, then zero basis is just a rule to promote economic waste by cumbersome steps. Giving the corporation the $100 basis automatically saves the expense and bother of the cumbersome steps.

The circle of cash theory argues that every acquisition of property for stock should be broken down into two steps, that is, first, the corporation acquisition of cash for stock and, second, a use of the cash to acquire the property. The courts, in other circumstances, have been willing to give a taxpayer deduction for costs borne by another party at least where it is possible to hypothecate a tax-exempt transfer to the taxpayer as an intermediate step.[153] They have also been willing to give corporations a deduction for expenses borne by shareholders by breaking down the shareholder

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152. *See, e.g.*, B. Bittker, Federal Taxation of Income, Estates and Gifts ¶ 4.3.5 (1981) for a fine short discussion. Chirelstein & Lopata, *Recent Developments in the Step Transaction Doctrine*, 60 Taxes 970, 974 (1983) argue that step transaction analysis should not defeat a good substantive tax result, but the question at issue here is whether fair market basis is a good substantive result.

153. Patrick v. United States, 186 F. Supp. 48, 52 (D.S.C. 1960), *aff'd on another issue*, 288 F.2d 292 (4th Cir. 1961), *rev'd on another issue*, 372 U.S. 53 (1963) (hypothetical intermediate step was loan to taxpayer); Royal Oak Apartments, Inc. v. Comm'r, 43 T.C. 243 (1964) (interim step was satisfaction of loan).

payment as first a contribution by the shareholder to the capital of the corporation and then a payment of the expense by the corporation.[154] Thus the circle of cash theory, far from collapsing the interim steps, views the reality of the transaction as naturally two steps, each using cash, under which the corporation gets a fair market value basis for the property.

But if zero basis were the proper principled result, the tax law need not haplessly give a fair market value basis instead. Even if the acquisition of property for stock is indistinguishable in practice or substance from an acquisition of cash for stock, still consistency can be achieved by preventing the corporation from increasing basis in both the cash and the property situations. Under current law, section 362(c) treats corporations as having a zero basis in property contributed by nonshareholders and it enforces the zero basis rule by providing that cash transfers from nonshareholders are "reimbursements," which are tax exempt but which reduce the corporation's tax basis. If the cash is not earmarked or identified with specific property by the parties, then the regulations invoke automatic rules to identify which properties will lose their basis.[155] Cash can be left to have its basis, while a remedy like section 362(c) simultaneously prevents the corporation from increasing its basis because of costs borne by outsiders. Cash and property can both be treated consistently as not increasing the corporation's net basis. There is accordingly nothing necessary in the circle of cash theory that says that the treatment of sales of stock for cash implies that a corporation has to have a fair market value basis in stock.

The current theories used to justify the corporation's fair market value basis are, in sum, not sound and do not legitimate the results.

II. The Present Value Theory

Although the rationales previously put forward to support the result are not very satisfying, this part argues that a corporation should indeed get a basis equal to the fair market value of its stock for property acquired with its own stock. The theory is that the

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154. Pierce Oil Corp. v. United States, 77 F. Supp. 273 (E.D. Va. 1947) *rev'd on another issue*, 169 F.2d 542 (4th Cir. 1948); Treas. Reg. § 1.83-6(d) (1978) (treating shareholder payments directly to employees of the corporation as if in fact made first to the corporation and then to the employee).

155. Treas. Reg. § 1.362-2(b) (1977).

fair market value basis arises as a proxy for the post-tax cash distributions that the corporation will make on its stock in the future. Part A. first presents the present value theory. Part B then applies the theory to various issues of current law.

A. *THEORY*

A corporation should get a fair market value basis (or a deduction) for property acquired with its own stock because the fair market value of the stock ordinarily represents the discounted present value of post-tax, nondeductible cash distributions that the corporation will make on the stock. By issuing the stock to acquire business property or pay a business expense, the corporation has committed a great deal of cash to a stranger and the corporation should be given tax recognition for that cash. Giving basis or a deduction upon issuance of the stock gives the corporation advance credit for the post-tax cash distributions that it will make only in the future. But giving advanced credit only for the present value of the cash distributions ensures that the early tax recognition is no advantage. The value of the stock is a fair proxy of the future cash expenditures the corporation will bear.

1. Business cost

Stock issued in a transaction fully taxable to the other side represents an expenditure by the corporation. By issuing the stock, the corporation is committing itself to distribute a large sum of cash on that stock over the years. The corporation should get tax recognition for its commitment to expend that cash to buy business property or pay a business expense because the corporate tax is a tax on income, that is, on revenue net of expenses. It is a fundamental principle of the tax that the costs of generating the revenue coming in must be subtracted at some point to calculate taxable income.[156]

When a corporation issues stock in a reorganization or tax-free incorporation, the issuance of stock is considered to be not an expenditure or purchase by the corporation but rather a certificate of ownership or membership in the pool. When a corporation is formed by a number of individuals, for instance, the individuals

156. *See, e.g.*, Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185-87 (1918) (inferring a deduction for cost of inventory sold, although there was no express deduction in the statute).

are joining together into an aggregation or pool. The corporation being formed is an artificial entity that has no expenditure; it is simply determining who its owners will be.[157] Because of the carryover basis provisions, no acquiring corporation in a tax-free reorganization or section 351 transaction gets any tax benefit for the cash or other consideration it gives out, except as that consideration is reflected in the transferor's gain.[158] The rule can easily mean that the corporation will pay out very considerably more cash for an acquisition of property than will be reflected in the basis of the property.[159] Neither the stock nor the cash distributed on it is considered to be an expenditure that needs to be taken into account in the calculation of profits. The distributed cash is treated as a distribution of profits rather than a payment for business property or business expenses.

When, however, the acquisition with stock fails to be a reorganization or tax-free incorporation, even for some highly technical reason, the acquisition is treated as a purchase and the corporation is treated as having made an expenditure with its stock.[160] The requirements for a reorganization are sometimes arbitrary. The continuity of interest doctrine, which distinguishes between disguised sales and real reorganizations, contains many rules that could not be deduced or re-engineered from policy principles alone. A corporation issuing 80.001 percent of its shares for property may have no

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157. *See, e.g.*, Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 TAX L. REV. 159, 164 (1984) (the issuer of stock is acquiring new owners, not selling property). *Cf.* ACCOUNTING PRINCIPLES BOARD, *supra* note 123, ¶¶ 16, 29, 42 (1970) (issuance of voting stock in business combination reported under a pooling of interest method of accounting is considered to be a rearrangement of ownership of the firm and not a purchase of assets).

158. I.R.C. § 362(a)&(b). *See, e.g.* B. BITTKER & J. EUSTICE, *supra* note 5, at ¶ 3.11 (payments on debt securities issued under section 351 without taxation to the transferor do not increase corporation's basis for assets acquired).

159. In Schweitzer & Conrad, Inc. v. Comm'r, 41 B.T.A. 533, 545 (1940), for instance, the acquiring corporation in a tax-free merger paid out consideration of over $2 million, including cash of $1 million paid to the shareholders of the acquiring corporation, assumption of the corporation's liabilities, and over $1 million dollars worth of preferred stock paid to shareholders of the acquiring corporation. Nonetheless, the acquiring corporation was required to carry over the merged company's modest $590,000 basis in its assets. None of the kinds of consideration created gain to the transfering corporation (although the cash created considerable gain to the shareholders of the transfering corporation), so that none of the consideration affected the carryover basis under the predecessor of section 362(b).

160. *See, e.g.*, Chapman v. Comm'r, 618 F.2d 856, 867 (1st Cir. 1980) (prohibition of boot in a B reorganization is "somewhat arbitrary" but it is valid distinction between sale or purchase arrangement and a mere change in form of ownership). *Cf.* ACCOUNTING PRINCIPLES BOARD, *supra* note 123, ¶¶ 45-48 (1970) treating corporate acquisition with stock as a purchase that increases acquirer's costs unless certain stringent requirements are met.

expenditure, but if the corporation issues only 79.999 percent of its shares to transferors of property, then the stock is an expenditure by the corporation and taxable to the recipients.[161] Transactions that are a pooling of interest and transactions that are a purchase by the corporation are mutually exclusive.[162] The legal characterization of a transaction as a taxable sale or as a continuity of interest transaction governs not only whether the shareholder's receipt of stock is taxed, but also whether the corporation may treat the stock as an expenditure.

The case law treating the issuance of stock as an expenditure admittedly arose under conceptions that the corporation should get a basis because of the value of the consideration it paid out or because the property received for the stock was the corporation's initial capital. As discussed in part I, neither theory now makes much sense. But the perception that stock sometimes represents an expenditure is still sound: By issuing stock to a stranger who has no privity or carryover relationship with the corporation, the corporation has committed a great deal of its cash to the stranger to pay a business expense or to acquire a business asset. Shares representing some fraction of one percent of an interest in the corporation, for instance, issued for property or services to a stranger to the corporation long after the initial pool was formed, give the new shareholder no prospect for influence over the management or assets of the corporation. The new shareholder must look solely to the future cash to be distributed on the stock to provide value for his property or services given up. Symmetrically, the corporation too must look at the stock as a proxy for the cash that will be distributed on the stock. The stock would be worthless paper except for the cash to be distributed on it.

If tax recognition for expenditures with stock were denied, a corporation would achieve the same basis or deductions by the same distributions of future cash. The corporation could agree to pay for the property, for instance, by agreeing to pay the stranger selling the property with a "phantom stock" plan under which it agreed to pay cash to the stranger to match distributions that it pays on some given number of its shares. The corporation then would get full tax recognition for the cash distributions it will

161. I.R.C. § 351 by reference to I.R.C. § 368(c) (80% control required).

162. *See, e.g.* ACCOUNTING PRINCIPLES BOARD, *supra* note 123, ¶ 43 (pooling of interest accounting and purchase accounting are not alternatives in accounting for the same business combination).

make to the stranger for the property. This transaction is economically equivalent to the issuance of stock because the stranger whose interest in the corporation is so small cannot consider the vote or control aspect of the stock to be significant. The fair market value basis or deduction for the stock itself is only a proxy for the basis or deduction that the corporation could have achieved and should achieve for the cash that it has committed to the stranger.

2. Stock represents the present value of future cash

Basis or a deduction for the fair market value of the stock is a fair proxy for the future cash to be distributed on the stock. In theory, the value of stock is nothing but the discounted present value of the future cash that the investor can expect to get by reason of her ownership of stock.[163] If the stock is sold on an efficient market, any systematic or ascertainable differences between the sale price of the stock and the present value of the expected future cash flows will be corrected by knowledgeable buyers or sellers entering the market on one side or the other to change the sale price. Variations between the present value of the cash flows and the fair market value will thus be random and unknowable.[164]

Giving the corporation a basis or deduction when the stock is issued gives the corporation advance credit for cash that it will pay out only in the future, but if valuation is right, it gives the corporation no advantage. Discounting (at a discount rate that is after-tax to the corporation) translates the future cash distributions into their equivalent, lesser expenditure now.[165] Present value is the

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163. *See, e.g.*, T. Copeland & J. Weston, Financial Theory and Corporate Policy 21-22 (3d ed. 1988); Pogue & Lall, *Corporate Finance: An Overview* in Modern Developments in Financial Management 27-28 (S. Myers ed. 1976). The cash the shareholder expects to receive includes both distributions by the firm with respect to the stock and the proceeds of sale of the stock, but the sale price of the stock is in turn only a proxy for the net present value of the cash distributions to be expected from the stock after the point of sale because a rational buyer would pay only for the net present value of the subsequent cash flows.

164. *See, e.g.*, Malkiel, *Is the Stock Market Efficient?*, 243 Science 1313 (Mar. 10, 1989); Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 384 (May 1970) (in an efficient market, actual price will be best estimate of intrinsic or net present value price, so that variations between actual and intrinsic price will be random).

165. In a system of double taxation of corporate income, the discount rate is post-tax to the corporation, which must pay tax on returns committed to pay shareholders, but the discount rates must be as high as the pretax rate that shareholders can get from their other taxable investments to attract the shareholders away from those other investments. Corporations can sell stock only if they can be expected to achieve a return after paying their own

amount that needs to be set aside now to satisfy a future payment at a given after-tax discount rate.[166] If the corporation's discount rate and hence present value is the same as the shareholders' discount rate,[167] then the value of the stock to the shareholders is also the amount that the corporation could set aside now, in an account growing at its general discount rate, to satisfy all the distributions the corporation is expected to make on the stock.

Allowing tax recognition of the present value, calculated at an after-tax discount rate to the corporation, can be viewed as a variation of the cash method of accounting.[168] The corporation can be viewed as setting aside a hypothetical account when the stock is issued to satisfy distributions on the stock; the fair market value basis is just giving tax recognition to that set aside. The corporation continues to pay tax on the fund set aside so that the early deduction does not give the corporation any tax relief on the income from the set-aside fund.[169] If the present value is calculated correctly, the corporation would be indifferent between getting a deduction for the present value or on getting a deduction for the cash.[170]

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tax that is as high as shareholders get from other sources before paying any tax.

166. The present value of amount *A*, which will be paid (or received) after *n* periods, given an available after-tax return rate (discount rate) of *i*, is equal to *A/(1 i)n*, because *A/ (1 i)n* will grow to equal *A* after *n* periods of compound growth at rate *i*: By definition, [*A/ (1 i)n§((1 i)n* = *A*. Explanations of the fundamentals of present value include J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 16-27 (5th ed. 1980); A. ALCHIAN & W. ALLEN, UNIVERSITY ECONOMICS 205-09 (2d ed. 1967).

167. A firm maximizes the net present value of future cash distributions on its stock by making investments that maximize the net present value of the future cash flows to the firm, using the shareholder's discount rate as its discount rate to measure net present value. *See, e.g.*, T. COPELAND & J. WESTON, *supra* note 163, at 21.

168. Johnson, *Silk Purses from a Sow's Ear: Cost Free Liabilities Under the Income Tax*, 3 AM. J. TAX POL'Y 231, 239 (1984).

169. If by contrast, a pre-tax discount rate were used and then allowed an interest deduction as the discount expired, the corporation would be exempt from tax on the interim earnings, up to the discount rate used, from the time of the deduction until the actual distribution. *See infra* note 173 and accompanying text.

170. To illustrate, assume that stock is issued to pay compensation or some other current business expense and that a $100 distribution will be made two years after the stock is issued. Assume that corporation, paying tax at 25%, can get a return of 10% on its investments, after tax. Given that return, the corporation can satisfy the $100 distribution by setting aside $82.65 at the time of issuance as a reserve for the distribution. (The $82.65 will grow to $90.90 after one year and $90.90 will grow to the needed $100 by the end of the second year.) A deduction of the fair market value of the future distribution, calculated using the 10% after-tax discount rate, would allow $82.65 to be deducted when the stock issued.

Allowing a deduction of the $82.65 present value on stock issuance, and no more later, has the same effect under the given assumptions as allowing a deduction of the $100 when it

Under a present value rationale, giving the corporation early tax recognition for the cash it will pay out in the future necessarily entails a deduction of less than the total amount of cash to be distributed on the stock. By contrast, traditional accrual accounting was blind to the time value of money and gave both advance credit for amounts to be paid in the future and a deduction for the full amount of the payment.[171] If this approach were followed in determining the basis of property acquired by issuance of stock, the basis would be the full amount of the expected future distributions, which would *exceed* the fair market value of the stock.

The present value rationale explains why deductions for stock are not double deductions and why the use of stock has no genuine tax planning advantage over using cash. When a corporation gets a deduction for the use of cash it has just received or has previously paid tax on, the deduction is viewed as a refund of the tax the corporation has paid in the past to keep the cash (or as preventing a tax on cash that will be disbursed as an expense by year end). By contrast, a corporation's issuance of its own stock gives the corporation a source from which to pay expenses which is already tax free, so that the tax saved is no refund. The corporation will, how-

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is paid two years hence. Assume the corporation makes $82.65 at the time the stock is issued that it commits to the expense but does not deduct. The corporation could keep only 75% of the income or $61.98 after tax. At 10%, the $61.98 would grow first to $68.18 and then to $75 by the end of two years. The $75 the corporation has at the end of two years is, however, enough to pay the $100 cash payment. If the $100 is deductible as a business expense, its payment saves $25, given the taxpayer's 25% tax rate, and the after-tax cost of the $100 is only the $75.

If on the other hand, the deduction of the $82.65 present value were allowed when the stock is issued, the full $82.65 unreduced by tax could be set aside without reduction by tax. The $82.65 would grow to $90.09 and then to $100. Since there is no second deduction of the expense when paid, the cash distribution costs $100 even after tax, which is the amount in reserve. In sum, with the correct assumptions about the tax rate, the discount rate available to the taxpayer, and the length of time between deduction and payment, allowing a deduction for the present value of future cash distributions has the same economic impact as allowing a deduction only for the cash when paid.

171. *See, e.g.*, the criticism of deduction of undiscounted accrued liabilities in Johnson, *supra* note 168, at 231-36, 242-45, 281-84. The post-tax discounting to reach fair market value of the stock is very different from "original issue discounting" or "accounting discounting" that treats the corporation as if it had borrowed money. Original issue discounting computes an "imputed principal" using given *pretax* discount rates. It then allows the corporation an interest deduction as interest is earned under compound interest rates. Computing fair market value of stock as shown in text by contrast seeks to compute how much needs to be set aside in a tax-bearing account to equal the future cash distributions; it uses post-tax discount rates to compute present value and then allows no further deductions as the discount rate expires. As long as tax rate variations do not offset the advantage, "accounting discounting" is more valuable to the taxpayer than the present value technique explained in the text. See the two discounting techniques compared *id.* at 245-63, 271-83.

ever, in the future pay tax on a great deal of cash distributed on its stock. Assuming that the stock's value equals the discounted present value of the future cash and that tax rates do not vary, the tax paid in the future will have a present value equal to the tax rate times the fair market value of the stock. The tax benefits that arise from use of stock offset the tax that will presumably be paid in the future on the cash distributed on the stock, just as the tax benefits that arise from use of cash to pay expenses merely offset the tax that has been imposed on the cash.

Giving the corporation a fair market value basis for property acquired with stock is ultimately consistent with giving the corporation a basis for property acquired with debt. Under what is sometimes called the *Crane* rule,[172] a taxpayer's basis for property acquired for debt includes the principal amount of the debt. The principal amount of a debt and the value of stock are analogues, both representing the initial principal on an instrument given by the corporation to acquire capital. For both debt and stock, the corporation is given advance credit in basis or by a deduction for cash that will only be paid in the future. Debt is treated more generously than stock, however, because the purchaser with debt may also deduct some of the cash as it is paid out on the debt instrument, namely, the interest. For stock, however, dividends are not deductible as they are paid, even though dividends are the functional equivalent for stock to the interest on a debt.

The differing rules for interest and dividends are fundamental to the current corporate tax system. The deduction of interest shifts the tax burden on a stream of income from the debtor corporation to the creditor.[173] There is only a single tax on debt-financed corporate income because the corporate debtor avoids tax on the corporate income stream committed to pay the interest. For stock-financed investments, by contrast, a corporation is taxed on the income and is not able to shift its burden to the shareholders who supplied the capital. The double tax on corporations requires that

172. Crane v. Comm'r, 331 U.S. 1 (1947). *See, e.g.*, Mayerson v. Comm'r, 47 T.C. 340, 352 (1966) (taxpayer gets "advance credit" for debt).

173. Hickman, *Interest, Depreciation and Indexing*, 5 VA. TAX REV. 773, 780 (1986); D. BRADFORD, UNTANGLING THE INCOME TAX 39 (1986) ("[t]he deduction of interest paid is simply the logical implication of the inclusion received."). *Cf.* Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506, 512 (1986) (arguing for discounting using a *pre*tax rate and allowing a deduction for interest in order to shift the tax burden on a stream of income from one party to a transaction, considered a "debtor," to the other party to the transaction, considered the "creditor").

corporations pay tax on the income, although it will also be taxed to the shareholders when distributed. The absence of deductions for the future dividends and other distributions, combined with discounting future distributions to be made on stock at an after-tax discount rate, ensures that the corporation will pay tax on the earnings committed to pay future distributions.

3. Departures from expectations

Stock can be expected to give a highly variable return, so that there is a difficult problem, under the present value theory, in distinguishing between inaccurate stock valuations, which should be corrected, and normal variations in the predicted return, which, it is argued here, should not be corrected.

Stock is different from debt because debt does not ordinarily participate in the profits of the corporation. Debt usually bears fixed interest, at negotiated rates, and the creditor will receive no more than principal plus the fixed interest no matter how successful the debtor is. For stock, by contrast, if the corporation prospers, the distributions that it will make on its stock will exceed the initial value of the stock by more than just a normal interest rate. A corporation issuing stock worth $100 can easily find that it distributes cash dividends many times more than the $100. Moreover, if the corporation does poorly, the corporation will pay out less than it anticipated on the stock, while debt interest and principal must be repaid, at least in theory, without regard to the health or profitability of the corporation. Both the corporation and the seller of property recognize that the cash actually distributed on stock will likely be different from the predictions. While debt may give a fixed return at the going interest rates, stock is expected to give a variable return that will be either higher or lower than the going interest rate and quite surely not equal to exactly the going interest rate. Any single interest rate or pattern of expected cash used by the parties to value the stock has to be just a weighted average within a wide range of expectations.

Under current law, and under the present value theory as well, the corporation would get no tax recognition for extra cash paid out on its stock even if the corporation is more successful than the parties anticipate. The fair market value of the stock is determined at the time that the stock is issued as an expenditure and changes in the value of the stock have no effect on the amount treated as the corporation's expenditure. The expenditure aspect of the stock ends when the stock is issued, so that if by hindsight the corporation pays out more or less cash to the stranger than the parties expected when they valued the stock, that reflects the shareholder's return as shareholder and does not retroactively change the corporation's expenditure in calculating its basis or deductions.

It would be possible, in theory, to keep track of the corporation's distributions on stock originally issued as an expenditure and adjust the corporation's deductions, if the distributions depart from their expected value. For example, if the stock considered to be an expenditure was valued at $100 when after-tax interest rates were 10 percent for comparable risks, and if the corporation makes distributions that exceed $100 when discounted at 10 percent back to the point of issuance, then the corporation would deduct the excess distributions when paid. If on redemption or liquidation the corporation had not paid out enough distributions on the stock, discounted back at 10 percent, to yield a $100 value, the shortfall would be taken into income. The system would be complicated, especially when the stock expenditure created basis rather than an expense deduction, but it would be possible.

If the issuance of stock is considered to be the expenditure for the business purpose, then departures from the expected distributions look like variations in the corporation's rate of return rather than variations in its expenditure. Corporate deductions should not vary based on its rate of return. If the corporation were allowed to deduct the unexpectedly large amount of cash that it distributes on stock when the corporation prospers, it would be exempt from tax on its supra-normal returns. The corporate tax, however, seems intended to be imposed on corporate profits that are higher than the normal, going interest rates.[174] Similarly if the corporation does poorly, it will pay out less cash or pay out cash later than implied by the fair market value assigned to the stock when issued. It would be absurd to impute taxable income to the poorly performing corporation as if it really made the profits that the parties expected in valuing the stock.

If stock issued for property is not systematically misvalued,

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174. Andrews, *Reporter's Study Draft (Supplemental Study)*, AM. LAW INST., FED. INCOME TAX PROJECT 88 (June 1, 1989), in fact, proposes a deduction for dividends on new corporate equity up to a level considered to be normal risk interest rate, *i.e.*, 2% above the federal long-term interest rate. The corporate tax would thus be left as a tax *only* on equity returns in excess of the normal risk interest rate. *But see*, Bulow & Summers, *Taxation of Risky Investments*, 92 J. POL. ECON. 20 (1984) (arguing for tax exemption for the premium return attributable to risk).

then in a wide sample, the adjustments made because the actual distributions depart from expectations would average out to give tax benefits with the same value as a system that ignored any change once the stock was issued. Individual corporations or shareholders would of course come out differently after the fact, but if valuation were correct, they would not know a priori, when the stock is issued and valued, in which direction the error was going to be. If they had known of the error, they would have changed the value of the stock.

In most circumstances, the stock will be valued accurately. In negotiating for the sale of property or services, the seller and the corporation must come to an agreement as to the value of the stock to determine how many shares to issue for the property or services. Their interests in valuation will ordinarily be adverse. For widely traded stock, the market value of the stock is legitimated by a large number of buyers and sellers who are setting the sale and purchase price of shares according to their independent appraisals of the discounted present value of the cash expected from the stock.[175] Even for closely traded stock, the value of the shares can be checked against the value of the property or services provided for the stock in comparable transactions.[176] But if the seller is taxable at roughly the same rate as the corporation, the tax detriment of overvaluation will usually hurt the seller, who will have an immediate tax liability, more than it helps the corporate issuer, who will commonly get only more basis. Even in cases in which the parties overvalue the stock, as determined by hindsight, the overvaluation is just a normal part of market fluctuations in the value of stock if the corporation could not have known of the overvaluation in advance.

If anything, the volatility and uncertainty of stock valuations will mean that the tax deductions the corporation obtains from issuing stock will be too low. Shareholders normally demand high discount rates to reflect volatility.[177] Minority shareholders are also outsiders who need to be skeptical of corporate claims; they must apply high discount rates to express skepticism even about projections that corporate insiders consider quite conservative. High dis-

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175. *See* Malkiel, *supra* note 164; Fama, *supra* note 164 (in an efficient market, actual price will be best available estimate of intrinsic or net present value price).

176. In an arm's length trade, the value of the stock given out necessarily equals the value of the goods or services given in exchange for the stock. Pittsburgh Terminal Corp. v. Comm'r, 60 T.C. 80, 88 (1973). *See* United States v. Davis, 370 U.S. 65 (1962).

177. *See, e.g.*, Pogue and Lall, *supra* note 163, at 33.

count rates, of course, mean low initial values for stock. Thus stock used as an expenditure can be expected to be systematically undervalued because volatility and skepticism will cause high discount rates. A corporation facing shareholders who demand high rates of return on stock will find that stock is an extraordinarily expensive way to pay out cash. Paying sellers and expenses with undervalued stock is neither good business nor a tax loophole.

A corporation generally has forgiveness of indebtedness[178] or tax benefit[179] income if it repays a debt with less cash than it received on incurring the debt. Tax benefits not paid for are reversed into income once it is clear that the debt did not in fact represent an economic detriment in the amount of the debt. There is no comparable doctrine for stock, requiring a corporation to report income if it fails to pay out the amounts it has received tax basis or a deduction for. The remedies for failure to pay debt have no time value of money element. Thus they would tolerate the corporation's paying only a low dividend return, less than expected in discounting the dividend stream to determine the value of the stock. But if the corporation fails to distribute even the amount of the initial basis or expense, then the corporation has received basis or deductions without any ultimate economic cost. The forgiveness of indebtedness or tax benefit rationale implies that the corporation should reverse the unpaid amounts into income.

In general, however, it seems wise to leave the failure to pay back the initial value of common stock as just an example of the unpredictability of stock performance, falling within the rule that the expenditure amount is measured at the time of stock issuance and not adjusted. The corporation's failure to repay a shareholder's initial investment affects the shareholder as a shareholder, not as a seller of property or provider of a service. The expenditure character of the transaction ended when the stock was issued.

Forgiveness of indebtedness income has an exception for insolvent corporations where the forgiveness of indebtedness does not free any assets of the corporation for general corporate use.[180] Fail-

178. I.R.C. § 108.

179. An accrual method taxpayer who deducts an expense when it is accrued, but then does not not pay the liability, must take into income the amount of the expense previously deduction. *See, e.g.*, Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 382 (1983) (citing Mayfair Mineral Inc. v. Comm'r, 456 F.2d 622 (5th Cir. 1972) (*per curiam*))

180. I.R.C. § 108(a)(1)(C); Haden Co. v. Comm'r, 118 F.2d 285, 286 (5th Cir. 1941) (debtor has income only to the extent company is solvent after forgiveness because only that represents assets freed from claims of creditors): Lakeland Grocery Co. v. Comm'r, 36

ure to pay the shareholder an amount of cash equal to the issue price of the common stock during the corporation's life can not free any assets of the corporate taxpayer for the benefit of the corporation or its owners. (Preferred stock, which does not participate pro rata in the profits of the corporation, is a distinguishable case. Common shareholders can in fact profit at the expense of preferred shares by failing to pay back the preferred amount.) But for common shares, a low payout would always fall within the no freeing of assets exception to forgiveness of indebtedness income.

There may also have to be some lookback device to prevent cases where the parties overvalue stock intentionally and the stock in fact represents less cash than claimed. The recipient of the stock may be in a low or zero bracket or in some other tax position so that overvalued stock does her no real tax harm; she might be willing to cooperate in the overvaluation of the stock for other consideration to give the corporation a larger deduction without using cash. Repurchases of stock at great discount in situations in which the repurchase might have been anticipated at the time of issuance should be very strong evidence of the true value of the stock. The step transaction doctrine, which collapses multiple steps without independent significance into a single transaction, should reach out to correct some abuses in which stock is issued and soon redeemed.

There may be room for special recapture or anti-abuse doctrines covering special cases. If, for instance, the corporation sells warrants to purchase its stock but the warrants expire without being exercised, it is known at the point of expiration that the corporation will pay out no distributions on its stock. The sale price of expired warrants should be treated as income or reduction of basis to the corporation.[181] But the abuses and special situations are best

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B.T.A. 289, 292 (1937) (*accord*).

181. The Deficit Reduction Act of 1984 amended section 1032 to provide that a corporation would recognize no gain or loss on a lapse or acquisition of an option to buy or sell its stock. Pub. L. No 98-369, § 57, 98 Stat. 494, 574. The Staff and Committee explanation of the reasons for the change said the purpose was to prevent a corporation from claiming a loss if the warrants went up in value, while asymmetrically not reporting gain if warrants went down in value or became worthless. STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 at 161 (1984). In truth that objection could have been met by treating the corporation's loss as clearly nondeductible, just like a redemption cost (see I.R.C. § 162(k)), or just clarifying that gain would in fact have to be reported if the corporation gained. The amendment enacted was more generous than the American Bar Association proposal that proceeded it, which would have required the basis of an issuer's assets to be reduced by the price it collected for issuing the warrant. The amendment represents one of the few instances where a corporation can achieve basis without recognizing income or paying cash. Pesiri, *Untangling the*

treated as errors in the valuation of stock or as special cases in which the stock clearly represents less cash than claimed. The possibilities of abuse do not seem serious enough to undermine a general rule that a corporation is entitled to a basis or expense for the fair market value of its stock issued in a transaction taxable to the recipient.

A corporation is under no obligation to pay out cash on its own stock and the stock is not a fixed liability.[182] The absence of a legally enforceable liability seems no necessary bar. The grounds of the fair market value basis for stock is not the accrual method, which does require a fixed liability before a deduction is allowed,[183] but rather a kind of cash method equivalency giving the corporation a basis or a deduction for the present value of the future distributions as if they were an immediate expenditure of cash. Traditional accrual accounting is, in any event, not a very sound ground for giving early deductions.[184]

B. *APPLICATIONS*

The theory that the corporation has an expenditure when it issues stock as a proxy for future post-tax cash distributions on the stock has a number of applications. One set of applications relates to treating the issuance of stock as an expenditure. Another set arises from problems because the corporation's distributions on stock are not always post-tax.

1. Stock as an expenditure

The theory that the corporation has an expenditure, equal to the present value of the distributions that are expected to be made on stock, supports not only the corporation's obtaining a fair market value basis for property acquired with stock, but also a number

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Warrant Web, 23 TAX NOTES 525, 545 (1984). It would be appropriate to tax the proceeds a corporation gets to keep upon a lapse (or cheap reacquisition) of an option to purchase its stock because, once it is clear that no stock will be issued, the cash or property the corporation receives for the option is not offset by any future post-tax cash distributions that the corporation will make.

182. *See* Kohl, *supra* note 40, at 648, (arguing that a corporation could not "conceivably be awarded advance credit" for payments on stock because the corporation is under no obligation to make the payments). For balance sheet purposes, stock once issued is considered part of the net worth of the firm rather than a reduction that needs to be subtracted to calculate the net worth, and distributions on issued stock are considered to be distributions of profits rather than expenses that need to be subtracted to compute profits.

183. Treas. Reg. § 1.461-1(a)(2)(1967).

184. *See, e.g.*, criticisms in Johnson, *supra* note 168, at 231-36, 281-84.

of other tax results available under current law. If stock is used to pay an expense item, such as services related to production of current income, the corporation has a deduction equal to the value of its stock.[185] The result is consistent with the basis result because an expense is simply an item whose basis has been recovered by the end of the current taxable year.

If a corporation pays off a liability with its own stock, the corporation can have forgiveness of indebtedness income, but only to the extent that the indebtedness that disappears exceeds the fair market value of the stock.[186] The result is consistent with the theory that the corporation has made an expenditure as if it had paid off the indebtedness in cash, up to the present value of the future cash expected to be paid on the stock.

The present value theory also seems to settle some issues on which there is currently doubt. The Service has ruled that a wholly owned subsidiary has zero basis in parent stock it uses to acquire assets because it carries over the parent's *zero* basis in its shares.[187] Under the present value theory, there does not seem to be any reason why a subsidiary or other taxpayer deriving its basis as a carryover from the corporation should not use the fair market value basis as its own. To the extent of its fair market value, the stock represents something as good as an expenditure by the parent corporation because it represents the present value of future cash. That present value, proxy-cash amount seems entitled to the same status for carryover purposes as cash that the parent has invested

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185. *See, e.g.*, I.R.C. § 83(h) and authorities cited *supra* note 2.

186. I.R.C. § 108(e)(10) ("the corporation shall be treated as having satisfied the liability for an amount of money equal to the fair market value of the stock."). *See also* Sen. Report on Bankruptcy Tax Act of 1980, S. REP. No. 1035, 96th Cong., 2d Sess. 11 (1980). Prior to the enactment of I.R.C. § 108(e)(10) in 1984 (Pub. L. No. 98-369, § 59(a), 98 Stat. 494, 576), a corporation never realized gain when discharging debt with its own stock, no matter what the fair market value of the stock, on the ground that issuance of stock repesented a substitution of one balance sheet obligation for another. Capento Sec. Corp. v. Comm'r, 47 B.T.A. 691, 695 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944).

Bryan, *supra* note 109, at 125-28, while disapproving of pre-1984 law, does so on the ground that a corporation should carry over the shareholder's basis in the liability. The result differs from the proxy cash theory advanced here only if transfer of the indebtedness by the new shareholder is a nonrealization event. See *supra* note 148.

187. Rev. Rul. 74-503, 1974-2 C.B. 117, result criticized, on the ground that stock is not property to the issuer and that cash contributions could achieve fair market value basis, in Banoff, *How IRS' New Zero-Basis Approach Will Affect Corporate Tax Planning*, 42 J. TAX'N 96 (1975); Banoff, *The Zero Basis Dilemma in Nonqualifying Triangular Acquisitions*, 41 U. CHI. L. REV. 92 (1973); Committee on Corporate Taxation, *Sale or Exchange by a Subsidiary Corporation of Its Parent Corporation's Stock*, 47 TAXES 146 (1969).

in some asset.[188]

The present value theory would also reverse current law as to costs of stock issuance. Current law treats the costs of issuing stock as an offset to the proceeds from the issuance of stock.[189] Because the proceeds of sale of stock are always tax exempt to the corporation,[190] treating the costs as offsets to the proceeds means that the costs are neither deductible nor basis creating. There is thus no deduction when the property acquired is sold or abandoned or when the corporation retires the issued stock. The theory that stock issued in a taxable transaction is a proxy for the future cash to be distributed on the stock implies that the cash used to pay the expenses of issuance is just another part of the corporation's expenditure to acquire the asset. If stock is issued for property in a taxable exchange, then the costs of issuing the stock seem to be appropriately treated as an addition to the corporation's basis for the acquired property. Similarly, costs associated with issuing stock to pay an expense are appropriately part of the corporation's

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188. The law sometimes makes a distinction between cash-generated basis and debt-generated basis in carryover situations. While a cash method shareholder achieves a basis with debt used to purchase property, she can not increase her basis in stock under section 358 by contributing the debt to her corporation. Rev. Rul. 68-629, 1968-2 C.B. 154 (contribution of note made to avoid impact of I.R.C. § 357(c)(1)); Smith v. Comm'r, 84 T.C. 889 (1985) (*accord*); Alderman v. Comm'r, 55 T.C. 662, 665 (1971) (*accord*). The shareholder would increase basis by contributing cash to the corporation.

On the other hand, regulations under pre-1986 law treated the fair market value of the corporation's stock and its debt as as good as cash as to taxation of corporate shareholders. Prior to 1988, section 301(b)(1) provided that a corporate shareholder had a dividend only to the extent of the distributing corporation's adjusted basis in the property, in order to prevent a step up in the basis of property at too cheap a tax price, given that corporate shareholders excluded most of the amount of a dividend. Treas. Reg. § 1.301-1(d)(1)(ii) (1979), written before the 1986 changes, nonetheless provided that the corporate taxpayer's dividend was the fair market value of distributed debt or the fair market value of a taxable stock dividend. The regulations, in sum, treated the stock as if it were basis for some purposes of subsidiary-parent tax. The 1986 Act, by requiring a distributing corporation to recognize gain on its distributions, raised the toll charge by enough that the step up in basis would not be too cheap, and obviated the need for the old § 301(b)(1) basis rule. Pub. L. No. 99-514, §§ 613(a), 631(a), 100 Stat. 2085, 2251 amending I.R.C. §§ 311, 336. Pub. L. No. 100-647, § 1006(e)(10), 102 Stat. 3342, 3401 amending I.R.C. § 301(b).

189. Simmons Co. v. Comm'r, 33 F.2d 75, 76 (1st Cir.) *cert. denied*, 280 U.S. 588 (1929) (commissions paid to sell stock just diminished the net return from the stock issuance and were not deductible); Van Keuren v. Comm'r, 28 B.T.A. 480, 486 (1933) (*accord*; expenses were equivalent to issuance of stock at a discount); Pacific Coast Biscuit Co. v. Comm'r, 32 B.T.A. 39, 42 (1935) (accord); Commercial Inv. Trust Corp. v. Comm'r, 28 B.T.A. 143, 148 (1933) *aff'd per curiam* 74 F.2d 1015 (2d Cir. 1935) (*accord*, stock was issued as employee compensation).

190. I.R.C. § 1032.

deduction.[191]

2. Proxy for post-tax cash

If the issuance of stock for property is recognized because it represents future post-tax cash, there cannot be a tax deduction for the cash distributions themselves. Conversely, if a deduction or exclusion is allowed for the cash distributions, the corporation cannot be given any positive basis or deductions for the stock to reflect future post-tax distributions. Allowing deductions for both the stock and the cash is a double deduction. With such double deductions, the deduction upon issuance of stock would not offset the tax the corporation will eventually pay on the distributed cash, but would offset the tax on some unrelated item that would have otherwise been taxed.[192]

The rule that a corporation should not get a deduction for both the stock and cash distributions on the stock has a number of applications. It plays a relatively minor role in supporting section 162(k) which provides that redemption distributions are not deductible. It means that earnings and profits and Subchapter S corporation accounts will have to be redone to prevent stock sales to noncontrolling shareholders from increasing basis. It does not mean any readjustment of partnership accounting, however, because the mere change in form rationale gives the partnership a universal carryover basis.

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191. The appropriate treatment of the costs of issuing stock becomes more complicated as to stock issued for cash because cash is fungible. Ideally there should be no difference between issuing stock directly for property and issuing stock for cash used in turn to acquire the property. Thus, for instance, if a corporation raises $90 worth of cash with a stock offering costing it $10, it should have a $100 basis in the property acquired with the $90 cash, just as it would have a $100 basis if the $90 stock were issued (at $10 cost) directly for the property. A purchaser's basis in property in general includes the transaction costs of acquisition, (*see, e.g.*, Woodward v. Comm'r, 397 U.S. 572 (1970) (transaction costs are capitalized)) and the corporation's cost of raising the $90 cash capital is plausibly part of its transaction costs. But given the fungibility of cash, it is impossible to know what cash really goes to. Even if the corporation can trace funds to a particular project, the allocation would be arbitrary since the funds devoted to the project free of funds for some other use. Under a balance sheet approach, the sources of funds are pooled and are in practice and theory independent of the uses of the funds. Thus the costs of issuing stock for cash would have to be allocated across all of the corporation's assets and expenses, undertaken within some period of the issuance of the stock. *Cf.* Treas. Reg. § 1.362-2 (1955) (allocating basis reductions from cash contributed to the corporation by parties not acting as shareholders). Stock issued to controlling shareholders, by contrast, would, under the argument of this Article, not be treated as corporate expenditures and, consistently, the costs would be treated as netting proceeds and not as expenditures.

192. See *supra* notes 32-34 and accompanying text.

a. Disallowance of redemption expenses

Section 162(k), enacted in 1986, provides that no deduction shall be allowed for "any amount paid or incurred by a corporation in connection with the redemption of its stock."[193] The law prior to 1986 sometimes allowed a corporation a deduction for redeeming out a shareholder, on an argument that termination of a disruptive shareholder was necessary for reasons germane to the corporation's survival in business.[194] In 1986 Congress prohibited the deduction, reacting specifically to prevent the deduction of "greenmail." "Greenmail" is the money that a corporation, vulnerable to hostile takeover, pays to a raider to redeem stock from the raider (usually at a considerable premium) and to prevent the raider from completing a hostile takeover of the corporation.[195]

The cleanest rationale for disallowing deduction of redemption distributions is that they, like dividends, are distributions of the corporation's profits, rather than subtractions that need to be made to compute profits.[196] A constant flow of distributions on stock, whether as dividends or redemption proceeds, may be quite ordinary and highly necessary for the corporation's survival, but they are still distributions of profits and nondeductible in a system that tries to tax corporate profits.

The present value theory also plays some role in reinforcing the disallowance of redemption costs. If the stock was considered to be an expenditure when issued, because the stock was a proxy for the future cash distributions, then the corporation can not also be allowed a deduction for the distributions themselves. Section 162(k) thus becomes similar to a rule that says that no taxpayer may deduct an expense *both* when it is accrued and when it is

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193. I.R.C. § 162(k) added by Tax Reform Act of 1986, Pub. L. No. 99-514, § 613, 100 Stat. 2085, 2251 as I.R.C. § 162(*l*) and renumbered as I.R.C. § 162(k) by Pub. L. No. 100-647, § 3011(b)(3)(A), 102 Stat. 3342, 3625.

194. Five Star Mfg. Co. v. Comm'r, 355 F.2d 724 (5th Cir. 1966) distinguished and questioned by Jim Walter Corp. v. United States, 498 F.2d 631, 639 (5th Cir. 1974); Markham & Brown, Inc. v. United States, 648 F.2d 1043, 1045 (5th Cir. 1981); H.& G. Indus., Inc. v. Comm'r, 495 F.2d 653, 657 (3d Cir. 1974); Harder Serv., Inc. v. Comm'r, 67 T.C. 585 (1976), *aff'd without opinion*, 573 F.2d 1290 (2d Cir. 1980); Proskauer v. Comm'r, T.C. Memo 1978-395 (P-H). *See* STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 at 277-78 (1987); Resnick, *The Deductibility of Stock Redemption Expenses and the Corporate Survival Doctrine*, 58 S. CAL. L. REV. 895 (1985).

195. STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 at 277-78 (1987).

196. *Cf.* Simmons & Hammond Mfg. Co. v. Comm'r, 1 B.T.A. 803, 808 (1925)(A corporation does not lose when it distributes surplus by agreement of its stockholders. Certain stockholders may suffer diminution, but this is not a loss to the corporation).

paid.[197] Not all stock is treated as a corporate expenditure when issued, but even then, the perspective here is that the corporation's expenditure is characterized and measured when the stock is issued.[198] When the stock issuance was not an expense, section 162(k) becomes similar to the rule that a corporation's payments on securities issued in a tax-free incorporation do not create either basis or deductions for the corporation.[199]

b. Accumulated earnings and profits

Under current accounting for the earnings and profits of a corporation, a corporation can get a double deduction for both stock and the distributions that give the stock its value. The double deduction should be corrected. A corporation's earnings and profits account determines whether a distribution is a dividend to the shareholders. Distributions are dividends taxed as ordinary income in full to the shareholder only if the corporation has current or accumulated earnings and profits. Distributions that are not out of earnings and profits are first a recovery of the shareholders basis and then capital gains.[200] A corporation using its stock can artificially strip its earnings and profits account because it can reduce its earnings and profits both when stock is issued and when distributions are made on the stock. The artificial reduction in the account allows the corporation to keep cash that disappears from the earnings and profits account and therefore to make nondividend distributions to its shareholders.

Assume, for instance, that *ABC Inc.* will pay out a $50 dividend on a share of its stock in each of the next two years. Further distributions as dividends or in redemption are considered quite remote and unlikely. The present value of the total distributions and hence the value of the stock, is $90. *ABC* uses its stock to pay (noncapitalized) compensation in year 1. *ABC* is entitled to a $90

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197. *See, e.g.*, McAdams v. Comm'r, 198 F.2d 54, 55 (5th Cir. 1952) (loan was deducted as drilling expense when incurred, so payment is not deductible); Consolidated Marble Co. v. Comm'r, 15 B.T.A. 193, 195 (1929) (repayment of loan incurred to construct railroad not deductible).

198. See Part II.B.3. *Cf.* Segall v. Comm'r, 30 T.C. 734, 739 (1958) (deductibility tested when loan was incurred).

199. *See, e.g.*, Schweitzer & Conrad, Inc. v. Comm'r, 41 B.T.A. 533, 545 (1940) and B.BITTKER & J.EUSTICE, *supra* note 5, at ¶ 3.11 (payments on debt securities issued in section 351 without taxation to the transferor does not increase corporation's basis for assets acquired), discussed *supra* notes 158-159 and accompanying text.

200. I.R.C. §§ 301(c), 316.

deduction for compensation. Accordingly, the corporation reduces earnings and profits by $90.[201] In the following two years, the corporation makes money, pays tax on the money, and has enough left to pay the two $50 distributions. Its earnings and profits account is net zero in those two following years: the corporation increases earnings and profits by the money it makes to pay the $50 distributions, but the corporation also reduces earnings and profits by corporate taxes paid on the money it makes and also by the $50 distributions.[202] While distributions are not deductible in computing corporate income tax, distributions are subtracted from the corporation's earnings and profits account because they represent money no longer available for distribution. The net impact of the whole transaction is to give the corporation a subtraction from its earnings and profits of $90 at the issuance of stock. If the corporation had $90 of profit from some independent source generating current or accumulated earnings and profits, the $90 subtraction would wipe out that account. *ABC* would still have the $90 cash, but the earnings and profits account would not reflect it. The corporation would thus be able to make a $90 nondividend distribution to its shareholders.

The same phenomenon can save the corporation from difficulty with the accumulated earnings penalty tax.[203] If *ABC* corporation had $90 of cash accumulated beyond the reasonable needs of the business, it could wipe out the accumulated taxable income account and immunize itself from the accumulation penalty tax, while keeping its $90 cash on hand without business justification.[204] The double deduction for both stock and cash misdescribes

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201. Both the Code and regulations "ordinarily take taxable income as the point of departure." B. Bittker & J. Eustice, *supra* note 5, ¶ 7.03 at 7-13. Section 83(h) allows a deduction for stock compensation.

202. I.R.C. § 312(a)(distributions reduce earnings and profits); Rev. Rul. 63-63, 1963-1 C.B. 10 (taxes—reduced by investment tax credit—reduce earnings and profits).

203. Sections 531-537 impose a penalty tax of up to 28% on accumulated taxable income of a corporation formed or availed of to avoid shareholder tax by accumulating income instead of distributing it to shareholders. Corporations are presumed subject to the tax if they accumulate beyond the reasonable business needs of the corporation (I.R.C. § 533) and corporations reduce the amount subject to the tax by accumulations retained for the reasonable needs of the business (I.R.C. § 535(c)).

204. There is a minor technical difference between the dividend issue and the accumulated penalty tax issue as to the treatment of redemptions. A redemption qualifying as a sale or exchange under I.R.C. § 302 takes out a prorata share of the corporation's total earnings and profits, used to determine dividend treatment (I.R.C. § 312(n)(7)), but reduces accumulated taxable income, subject to penalty, only if it is in liquidation of the corporation (I.R.C. §§ 535(a), 561(a)(1), 562(b)). *See* Doernberg, *The Accumulated Earnings Tax: The*

the corporation, treating it as if it had paid out money that it still has on hand.

In theory the double deduction could be fixed either at the time of issuance or at the time of distributions. The double deduction theoretically could be fixed by changing the treatment of distributions. The stock issuance would continue to be treated as generating basis or deductions, but distributions on the stock, whether dividends or redemptions, would not reduce the corporation's earnings and profits.[205] Distributed earnings and profits, however, clearly should not be treated as if they were still accumulated. A corporation that has distributed all of its cash is different from a corporation that has all of its cash on hand, no matter how the stock was treated when issued. The corporation that has distributed all its cash has no unreasonable accumulations and it has no accumulated earnings from which to make a dividend distribution. A prosperous corporation might well have issued stock that was worth the same as the stock of its failing fellow corporation at the time of issuance, but both accumulated earnings penalties and the dividend treatment would want to make a distinction between the prosperous and the losing corporation. Treating the prosperous and losing corporations as having the same amounts to distribute, simply because they originally issued the same value stock, misdescribes their differences.

It follows, therefore, that to prevent double deductions there should be a denial of basis or expenses in the earnings and profits account for expenditures accomplished with stock. If the stock creates basis under the normal corporate tax, that basis should be subtracted in adjusting the earnings and profits account for taxable income. If the stock created expenses, the earnings and profits account needs to reverse the expense.

Current law has it exactly backwards: a corporation is given a reduction in earnings and profits even for qualified stock compensation transfers that are not deductible under normal corporate

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Relationship between Earnings and Profits and Accumulated Taxable Income in a Redemption, 34 U.FLA.L.REV. 715 (1982).

205. Under current law, redemptions are commonly treated at least in part as not out of earnings and profits (I.R.C. §§ 312(n)(7); 562), but, if the stock is outstanding for many years, the present value of amounts that do not reduce earnings and profits can be expected to be a very small portion of the total value of the stock. The disallowance of a reduction needs to extend to distributions making up all of the present value of the stock, *i.e.*, to all distributions.

tax.[206] The analysis here shows that the corporation should be denied a deduction in computing earnings and profits for stock used as an expenditure even if it was allowed a deduction for income accounting.[207]

A rule to be effective in reversing the basis or expense derived from stock issuance would have to cover sales of stock for cash. A corporation facing an adverse tax treatment for direct use of stock as an expenditure could avoid the rule by issuing the stock for cash instead and then using the cash to make the expenditure. A seller or service provider who wanted stock could use the cash received from the corporation to buy it. For sales of stock to controlling shareholders, the corporation's basis or expense would be justified as a carryover of the shareholder's basis, but a premise of the argument for the superiority of the present value theory is that basis does not carry over from noncontrolling shareholders.[208]

The best remedy is to treat the cash that comes from a noncontrolling shareholder as a reimbursement by a stranger that reduces the corporation's basis or expense for the purposes of the earnings and profits account. When the circumstances do not identify which corporate expenditures were reimbursed by the cash proceeds of the stock sale, there needs to be some system of automatic pro rata reductions of earnings and profits.[209] Even when the corporation can trace its use of funds to a particular asset, allocating basis reduction to that asset would be artificial since the contributed funds free up money otherwise committed to the asset for some other uses. A simpler remedy, which would avoid all of the complexities of allocating basis reductions, would be to just increase earnings and profits by the proceeds from sale of stock to noncontrolling shareholders. The simpler remedy would, however, sometimes be too hard on the corporation when in theory it needs only a deferred increase in earnings and profits by way of a reduction of some basis. The treatment of cash sales of stock, in earn-

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206. Divine v. Comm'r, 500 F. 2d 1041, 1057 (2d Cir. 1974) (qualified stock option represented expenditure by corporation in computing earnings and profits, although not deductible for income tax purposes); Luckman v. Comm'r, 418 F.2d 381, 384 (7th Cir. 1969) (*accord*).

207. Consistently, redemption proceeds on stock given out as an expenditure would reduce earnings and profits if the issuance was not treated as the expenditure. Current law treats redemptions as in part not out of earnings and profits. I.R.C. §§ 312(n)(7), 562(a)&(b).

208. See text accompanying *supra* notes 118 through 148.

209. *See, e.g.*, Treas. Reg. § 1.362-2 (1955) (allocating reduction of corporate basis arising from contributions from parties not acting as shareholders).

ings and profits accounting, seems independently justified: if the corporation sells stock constituting a minority interest in the corporation and then distributes the cash received as dividends and redemption proceeds, the net effect on accumulated earnings and profits should be zero and not a net reduction or stripping of the earnings and profits.[210]

c. *Partnerships*

Partnerships are always entitled to a carryover basis from their owners, even noncontrolling partners. Thus for partnerships a carryover theory rather than a present value theory explains the partnership results. The present value theory does not justify a partnership's basis or deduction from use of its partnership interest to pay a partnership expense. A corporation should be given basis or expense for use of stock because the stock represents the present value of future post-tax distributions it will make. But a partnership pays no tax on amounts distributed to its owners. To be given advance credit when it issues a partnership interest for the post-tax cash it will distribute, a partnership must be given no basis and no deductions. Even if we view a partnership as merely an aggregation of individual partners, the old partners do not need a tax deduction when a partnership interest is issued to a stranger. The old partners avoid tax on the cash distributions given to the stranger because they have diverted the cash to the stranger and no partner is taxed on another partner's distributable share.

The historical owners of a partnership in fact get double deductions when the partnership issues partnership interests to a stranger. Assume, as in the earnings and profits hypothetical, that

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210. Widely held corporations issue shares only to new shareholders who do not meet the 80% control requirements. Under the proposed rule, outside a tax-free reorganization, a widely held corporation could use stock sales to generate expenditures that deplete earnings and profits only in very rare circumstances. But the earnings and profits limitation on dividends, as defined for tax purposes, is already largely irrelevant for shareholders of a widely held corporation. Why should a shareholder who has recently purchased his shares on a public market separate taxable dividends from nontaxable recovery of capital according to the complicated history of the corporation long before he held his shares? If the treatment of stock issuance proposed here would erode the importance of earnings and profits, so be it. For a sample of the literature urging elimination of the earnings and profits account to identify dividends, see Colby, Blackburn & Trier, *Eliminating Earnings and Profits From the Internal Revenue Code*, 39 TAX LAW. 285 (1986); Blum, *The Earnings and Profits Limitation on Dividend Income: A Reappraisal*, 53 TAXES 68 (1975); Andrews, *"Out of Its Earnings and Profits": Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403 (1956).

a partnership gives a partnership interest worth $90 as compensation to a new employee and then distributes two $50 amounts on that partnership interest, justifying the $90 valuation. The partnership gets to deduct $90 when it issues the partnership interest as compensation and the historical partners would get to share in that deduction. The historical partners would also divert the two $50 income items away from themselves. To properly tax the historical partners, it is sufficient to account for the $50 cash distributions alone as diversions away from the old partners. The extra $90 deduction arising from the use of the partnership interest as compensation would shelter from tax cash that the partnership has actually retained and not distributed to the new partner.[211]

The partnership's basis arising from an expenditure use of partnership interests is nonetheless fully legitimated by a carryover basis and circle of cash theory. The partnership could have achieved a $90 deduction for the compensation by selling the partnership interest for $90 cash and then using the $90 cash to pay the compensation. A stranger receiving the compensation who wanted to become a partner could use the cash compensation to buy the partnership interest. There would be a circle of cash so that the use of the cash would be temporary, but as long as partnerships can acquire cash tax free,[212] the cash will create expense deductions or basis for the partnership.

In the earnings and profits account, it was possible to treat cash from noncontrolling shareholders as reimbursements reducing the corporation's costs in recovering the corporation's basis. That remedy destroyed the efficacy of issuing stock for cash rather than directly as an expenditure.[213] But that remedy is inappropriate for partners. There is no control requirement for a tax-free contribution to a partnership[214] and partnerships are therefore always entitled to carry over their partner's basis.[215] On this issue, partner-

211. Because partnership level deductions reduce a partner's basis (I.R.C. § 705(a)), the sheltered $90 cash could not be distributed to the persons who are partners when the partnership took the deduction without causing them to eventually pay tax on the $90. But the $90 would not be taxable until the partners had used all of their other basis in their partnership interests (I.R.C. § 731), which might take a while. Sheltering cash held by the partnership, moreover, is a very significant advantage that allows the partnership to go into any investments with soft, untaxed money instead of hard, after-tax money. *See, e.g.*, Johnson, *supra* note 168.

212. I.R.C. § 721.

213. *See* discussion in text accompanying *supra* note 208.

214. I.R.C. § 721. Compare I.R.C. § 351(a) (parenthetical reference to I.R.C. § 368(c)).

215. I.R.C. § 723.

ships are treated as aggregates. It makes no difference whether the costs are borne by the aggregation, *i.e.*, the partnership, or by the partners in their individual capacities. The partnership's costs always include the costs borne by the partners individually. Partners are never treated as strangers reimbursing and reducing the partnership's costs.

Once the new partner is considered in the equation as part of the transaction, the $190 total reduction in the old partner's income becomes no special advantage. The partnership's deduction of the $90 for the issuance of the partnership interest was a cost that was borne by the new partner. Break the transfer of the partnership interest as compensation into its components: first a transfer of cash by the new partner for the interest, then a refund of the cash by the partnership as compensation. Partnerships are aggregates, so that when a new minority partner gives $90 in cash to the partnership for an interest, the partnership should be able to deduct the $90 cash used to compensate the new minority partner, just as any partner could deduct the $90 when bearing a business expense. A new partner receiving $90 in cash compensation, which she invests in the partnership, must pay tax on the $90 compensation. The partnership gets a deduction that only reimburses the partners for the tax the new partner pays in the transaction. In the partnership use of contributed cash, historical partners share immediately in the deductions traced directly to the new partner's post-tax capital, but that is always true of partnership use of contributed partner funds.[216] Carryover basis thus seems to legitimate a partnership's basis or deduction from using its own partnership interest to acquire property or pay a deductible expense. The present value theory neither legitimates nor undermines current treatment of the issuance of partnership interests.

The carryover basis theory does seem to entitle a partnership to at least a partial exemption from cancellation of indebtedness income where a partnership gives a creditor an equity interest in return for cancellation of some of its debt. Under section 108(e)(10), a corporation can avoid cancellation of indebtedness income to the extent of the fair market value of stock it gives to the creditor in exchange for the debt. Under the theory that stock rep-

216. The employee given a new partnership interest would be a partner by year end and would thus share prorata in the expense deduction (I.R.C. §§ 702, 706(a)), but some of the expense would be apportioned to the old partners according to their distributive shares in the partnership at year end.

resents the present value of post-tax cash the corporation will distribute on its stock, that result is both right and not applicable to partnerships.[217] But a creditor who gives up debt in exchange for a partnership interest also becomes a partner and all partnerships have privity with their partners, including new and noncontrolling partners, and they are entitled to carryover the creditor's basis. To the extent the creditor has adjusted basis not recognized as a loss in the transaction, the partnership should be allowed to use the basis, as if it were a contribution to the partnership in cash, just as a corporation, under section 108(e)(6), avoids income to the extent of shareholder basis when a shareholder cancels debt. Section 108(e)(6) relies on a carryover basis rationale that should apply to a partnership.[218] The treatment of creditor and partnership must be consistent, however, as they were a single economic entity, meaning that the partnership gets basis that avoids the cancellation of indebtedness income only to the extent the creditor does not recognize loss. Tax accounting would describe the true economics of the situation if the equity for debt exemption were limited to fair market value of the partnership equity the creditor gets. The creditor would write off its basis in the debt only down to the fair market value of the new equity and the partnership would, consistently, be exempt from cancellation of indebtedness income only to the extent of the value of the equity it gives up. Once again, the taxation of partnership equity should follow from a carryover basis theory rather than from a present value of the future post-tax cash flows theory.

d. *S Corporations*

Like a partnership, an S corporation pays no tax on its income.[219] If it is to be given basis or a deduction for use of its stock solely to account for the future post-tax cash it will distribute on the stock, then for the S corporation the amount of the basis or expense would be zero. As with the earnings and profits account, a double deduction for both the issuance and distributions on S corporation stock would artificially strip taxable income, leaving the

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217. A recent review of the statute and cases suggests that there might be a common law equity-for-stock exemption that is available for partnerships. Sheffield & Maynes, *Selected Issues in Partnership Debt Restructurings*, 68 TAXES 861, 861, 874 (1990).

218. *See* Bryan, *supra* note 109, and discussion, *supra* note 148.

219. I.R.C. § 1363(a). As with a partnership, however, the owners of the entity pay the

corporation with retained cash that it has sheltered from tax.[220]

Unlike a partnership, however, the carryover basis or circle of cash theory does not universally justify the S corporation's basis. This is because an S corporation cannot universally claim that costs borne by the owners are the same as costs borne by the entity. S corporations are sometimes treated as separate entities when issuing stock, in circumstances in which partnerships are treated as aggregates.

Transfers of property to S corporations in return for equity are governed by section 351, rather than section 721; and for section 351 to apply, transferors of cash or property to the entity must "control" the corporation, that is, own 80 percent of its stock after the transfer. Transferors of property who receive S stock can treat the stock as a mere change in form only if the transferors of property together control the corporation, within the meaning of the 80 percent ownership requirement.[221] When the shareholders are treated as merely changing the form of their investment, the corporation will have a carryover basis. But where the transferors fail to qualify under section 351, the S corporation will treat the transaction as a purchase with stock. The basis or costs of noncontrolling shareholders then do not carry over to the corporation and if they do not carryover, the shareholder costs are appropriately treated as reimbursements by nonshareholders or shareholders not acting as such, which reduce the corporation's tax recognized costs. Because S corporations are allowed no more than 35 shareholders, it could be argued that all shareholders are friends of the corporation who can give it basis. S corporations so resemble partnerships on important issues—at least on the most important issue of liability for corporate tax—that it may be awkward to draw a distinction between S corporations and partnerships. Still, as long as existing law treats the control requirement as a prerequisite to a pooling or continuity of interest characterization, that legal characterization should govern the corporation's carryover of shareholder costs. Therefore, an S corporation should get no basis for property acquired (and no deduction for expenses paid) by issuing its own stock to noncontrolling shareholders.[222]

Denying the S corporation basis or expense from the issuance of its own stock requires a number of provisions to make the rule

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220. See discussion in text accompanying *supra* notes 200-204.
221. I.R.C. § 351(a) by reference to § 368(c).
222. *See* text accompanying *supra* notes 121 through 149.

effective. If issuance of stock for property or expense would give the corporation no basis or deduction, then a sale of stock to noncontrolling shareholders for cash should not be an opportunity for the corporation to achieve basis. Otherwise a corporation facing the no basis or deduction rule would want to pay for the item in cash and immediately sell stock for cash. Accordingly, sales of noncontrolling stock for cash should reduce the basis of some asset of the corporation. The remedy should not be limited to sales of stock and purchases of property that are sufficiently tied together to be collapsed under the step transaction doctrine. The step transaction doctrine is too easily avoided; only the unwary would be caught.

To maintain consistency, a regular C corporation upon becoming an S corporation should be required to reverse basis or expense items that it previously been allowed by issuing noncontrolling stock. The election of S corporation status by a corporation means that the corporation will avoid paying tax on the distributions it makes on the stock. Nothing in the bargaining between shareholder and corporation to determine the fair market value of the stock can take into account the corporation's later avoiding corporate tax by electing S status. The worst abuse would be using stock as an expenditure while still a C corporation, followed by an S election, thus negating the assumption underlying the present value rule that distributions would be post-tax. But even delayed elections, making some significant part of the corporation's distributions not post-tax, can affect a substantial portion of the original value of the stock. It would seem to be fairest to reduce basis and expenses automatically by some per se stacking method;[223] tracing of funds to particular projects would lead to purely arbitrary results.

The appropriate amount of the basis (or expense) reduction would seem to be the fair market value of the noncontrolling stock at the time of the S election. The fair market value of the stock at the time of the S election is a fair proxy for the cash distributions yet to come on the stock. The corporation would thus get tax recognition for its original issuance of stock to the extent of the cash distributed prior to the S election, but not for cash distributed after the S election. In any event, some recognition has to be given to the cash distributions that have been made; some recognition has to be given to distinctions between corporations that have accumu-

223. *See, e.g.*, Treas. Reg. § 1.362-2 (1955) (reducing corporation's basis upon a contri-

lated their earnings while they were C corporations and those that have distributed them; and some recognition has to be given to the fact that the reversal of the basis (or expense) occurs later than the original benefits of the basis (or expense). Treating the fair market value of the stock, at the time of the S election, as the amount of basis to be undone solves all of the problems.

III. Conclusion

A corporation appropriately has a basis equal to the fair market value of its stock when it acquires property with its own stock in a taxable transaction. The fair market value basis is legitimate, however, not because the stock is valuable consideration for the property, not because the initial value of the property is untaxable capital of the corporation, not because the corporation must preserve its initial exemption, not because the corporation carries over basis from strangers selling to the corporation, and not because the corporation could sell its stock for cash and use the cash to buy the property. None of those theories is satisfactory today.

Rather, the corporation properly has a fair market value basis in the property because its stock is a proxy for the post-tax cash that the corporation will eventually distribute on the stock. Stock issued in a transaction taxable to the recipient of the stock represents an expenditure by the corporation. If the expenditure is for business purposes, the corporation should get tax recognition in computing income for its costs. The fair market value of stock represents the present value of the future cash the corporation will distribute, as if the corporation upon issuing its stock had set aside a cash reserve to pay the cash distributions. The discounting of future cash at an after-tax discount rate to reach a present value of the stock ensures that the corporation will have no advantage in receiving tax recognition for the value of the stock long before it actually pays out the cash on the stock.

The theory taken seriously would both legitimate and amend current law. The present value theory, treating the fair market value of stock as a corporate expenditure, implies that expenses of issuing stock should gain tax recognition if the stock itself was considered an expenditure. It implies that a subsidiary should get a basis when it uses parent stock to acquire property or pay deductible expenses, just as it carries over a parent corporation's cash basis in other assets. It legitimates the exemption from forgiveness of indebtedness income, up to the fair market value of the stock, when a corporation exchanges stock for debt. It supports the disallowance of a deduction for redemption distributions because the theory that tax recognition of stock is a proxy for the *post-tax* distributions to be made on the stock implies that there should be no double deductions for both stock and cash distributed. The theory also requires amendment of the law to provide that stock issued to noncontrolling shareholders not be treated as an expenditure in the earnings and profits account. It also requires that S corporations not be allowed tax recognition for stock that they issue to noncontrolling shareholders.