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Tax Models for Nonprorata Shareholder Contributions

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TAX MODELS FOR NONPRORATA SHAREHOLDER CONTRIBUTIONS

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> Of all of these things, only "see it fresh," "see it clean" and "come back to make sure" are of the essence. They go to method. That method is eternal. . . . But the method includes nothing at all about whither to go. . . . Realism is not a philosophy, but a technology. That is why it is eternal. The fresh look is always the fresh hope. The fresh inquiry into results is always the needed check-up.
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> —Karl Llewellyn, The Common Law Tradition: Deciding Appeals 510 (1960)

When a shareholder transfers property[1] to or for the benefit of his corporation and receives no consideration in return, his remaining shares should increase in value. The increase will not be as large as the value transferred, however, if the transferor owns less than all the shares and if other shareholders do not join in the contribution.[2] One could speculate that without a gift motive[3] such nonprorata contributions should not occur. When neither the corporation nor the other shareholders are willing to pay the cost of the transaction, why should a shareholder who loses value in the transfer make a nonprorata contribution?

The best explanation is that the shareholder expected the investment to yield a profit even though he made it alone. Perhaps the corporation was near bankruptcy or in such financial distress

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[1] As used in this article the term "property" includes shares in the corporation as well as other noncash assets.

[2] Under the case law, if all shareholders join pro rata, gain or loss is not recognized. *See infra* notes 50, 143 and accompanying text.

[3] Gifts were accomplished by nonprorata contributions in Heringer v. Commissioner, 235 F.2d 149 (9th Cir.) (gift tax due on benefit to family shareholders), *cert. denied,* 352 U.S. 927 (1956); Chanin v. United States, 393 F.2d 972 (Ct. Cl. 1968) (same), and Mack v. Commissioner, 45 B.T.A. 602 (1941) (transfer considered a gift), *aff'd,* 129 F.2d 598 (2d Cir. 1942), but in the cases cited at *infra* notes 10, 13, 16, no gift motive seems plausible. Nonprorata shareholder contributions were also held to be gifts in Arata v. Commissioner, 227 F.2d 576 (2d Cir. 1960) and Hogan v. Commissioner, 35 B.T.A. 26 (1936), but these cases seem to involve little or no donative intent. *Cf.* Hoile v. Commissioner, 4 T.C.M. (CCH) 247, 253 (1945) (contribution to employer). The results are better explained by the courts' desire to deny the transferor a deduction. *See infra* text accompanying notes 122-59 (critizing allowance of deduction).

that it could not undertake the transaction. Creditors may have pressured for the contribution to allow the corporation to hire new management or obtain working capital. The shareholder thus could have lost his whole investment had he not made the contribution.[4] Other shareholders who did not participate had less invested or perhaps just considered the transaction unwise. Sometimes the explanation is that the contribution was so near to pro rata that the loss in the transfer was minimal,[5] and sometimes the courts simply ignored the fact that other shareholders gave consideration that balanced the shareholder's contribution.[6]

In over fifty years of cases, the courts, relying on familiar tax doctrines, have applied three mutually inconsistent models to nonprorata shareholder contributions. While each model imposes a different character and tax result on the transaction, each model has a rationale and a result that could govern all nonprorata contributions. Conflicting models have led to a large body of cases[7] and commentary.[8]

In the first model, the *Ames*[9] or "capitalization model," the shareholder's contribution is treated as an added cost of his remaining shares or as an added investment in the benefited corporation. The shareholder recognizes neither gain nor loss on the transaction, but adds his basis in the transferred property to the

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[4] *See, e.g.*, Crow v. Commissioner, 29 T.C.M. (CCH) 1321 (1970); Duell v. Commissioner, 19 T.C.M. (CCH) 1381 (1960); Payne Housing Corp. v. Commissioner, 13 T.C.M. (CCH) 603 (1954); Estate of Foster v. Commissioner, 9 T.C. 930 (1947); Miller v. Commissioner, 45 B.T.A. 292 (1941); Vaughan v. Commissioner, 17 B.T.A. 620, *aff'g on reh'g* 15 B.T.A. 596 (1929).

[5] *See, e.g.*, Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979).

[6] *See infra* notes 143-46 and accompanying text.

[7] *See* cases cited at *infra* notes 10, 13, 16.

[8] *See, e.g.*, Arlinghaus, *Tax Court Questions Validity of Restricted Property Regulations*, 59 Taxes 261 (1981); Bolding, *Non-Pro Rata Stock Surrenders: Capital Contribution, Capital Loss or Ordinary Loss*, 32 Tax Law. 275 (1979); Gebhardt, *When are Loss Deductions Available on the Voluntary Surrender of Stock*, 43 J. Tax'n 22 (1975); Landis, *Contributions to Capital of Corporations*, 24 Tax L. Rev. 241, 257-66 (1969); Manwell, *Transfers of Partial Stock Interests to Corporate Employees: A Composite Alternative*, 1 J. Corp. Tax'n 275 (1974); O'Brien, *Stock Transfers by Shareholders to Outsiders for Nontangible Consideration*, 39 Taxes 675 (1961); Stone, *Compensation Payments by Shareholders of Employer*, 30 Inst. on Fed. Tax'n 349, 354-57 (1972); Wagner, *Taxation of Stock Transfers Between Corporate Shareholders and Employees*, 31 U. Miami L. Rev. 43 (1976); Wray, *Transfers of Property by Shareholders to Corporate Employees Under Section 83*, 52 J. Tax'n 152 (1980).

[9] Ames v. Commissioner, 14 B.T.A. 1067 (1929), *aff'd*, 49 F.2d 853 (8th Cir. 1931).

basis of his remaining shares.[10] The rationale is that the cost arises from the shareholder's prior investment in his stock and relates to future returns on that investment. That rationale is plausible for all the cases.[11]

In the second model, the *Smith*[12] or "ordinary-loss" model, the taxpayer is allowed to deduct all or part of his basis in the transferred property as an ordinary loss.[13] This model allows the share-

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[10] *See* Tilford v. Commissioner, 705 F.2d 828 (6th Cir. 1983) (bargain sale of stock to employees); Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979) (stock transfer by shareholder to bolster corporation's financial position); Ward v. Commissioner, 18 B.T.A. 326 (1929) (surrender of cash bonds to corporation to induce new president to accept job); Vaughan v. Commissioner, 17 B.T.A. 620, *aff'g on reh'g* 15 B.T.A. 596 (1929) (surrender of securities to corporation to avoid closing of business); Ames v. Commissioner, 14 B.T.A. 1067, 1071-72 (1929) (surrender of corporate stock to corporate employees), *aff'd*, 49 F.2d 853 (8th Cir. 1931); S. Rep. No. 552, 91st Cong., 1st Sess. 123-24, *reprinted in* 1969 U.S. Code Cong. & Ad. News 2027, 2155 (no gain or loss recognized where stock is used to compensate employees under a restricted stock plan) [hereinafter cited as 1969 Finance Comm. Report]; Treas. Reg. § 1.83-6(d) (shareholder stock transfers to corporate employees as compensation are contributions to capital); G.C.M. 670, V-2 C.B. 115 (1926) (same). *Cf.* Deputy v. Du Pont, 308 U.S. 488 (1940) (incidental cash expenses of shareholder's stock sale to corporate employees were not expenses of shareholder's business); cases cited at *infra* notes 208, 216. *See also* Arrowsmith v. Commissioner, 344 U.S. 6 (1952) (involuntary cash expense arising from earlier capital transaction was capital loss); cases cited at *infra* notes 39-40, 159.

[11] The shareholder's transfer in cases reaching a result inconsistent with the *Ames* capitalization result is often described, notwithstanding the result, as a transfer made by the shareholder to increase the value of his remaining shares. *See, e.g.*, Berner v. United States, 282 F.2d 720, 727 (Ct. Cl. 1960); Smith v. Commissioner, 66 T.C. 622, 642 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979).

[12] Smith v. Commissioner, 66 T.C. 622 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979).

[13] *See* Scherman v. Helvering, 74 F.2d 742 (2d Cir. 1935) (deduction of bargain allowed on sale to employee); Northwest Motor Services Co. v. United States, 1960-2 U.S. Tax Cas. (CCH) ¶ 9488 (D.N.D. 1960) (100% shareholder allowed deduction); Kress v. Stanton, 98 F. Supp. 470 (W.D. Pa. 1951), *aff'd per curiam*, 196 F.2d 499 (3d Cir. 1952) (deduction of bargain allowed on sale to employee); Berner v. United States, 282 F.2d 720 (Ct. Cl. 1960) (deduction of bargain allowed on sale to employee); Peabody Coal Co. v. United States, 8 F. Supp. 845 (Ct. Cl. 1934) (loss allowed for entire basis); Smith v. Commissioner, 66 T.C. 622 (1976) (deduction of basis), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979); Duell v. Commissioner, 19 T.C.M. (CCH) 1381 (1960) (loss allowed for difference between book value of stock surrendered and increase in real value of retained shares); Payne Housing Corp. v. Commissioner, 13 T.C.M. (CCH) 603 (1954) (same); Estate of Foster v. Commissioner, 9 T.C. 930 (1947) (loss allowed for basis of shares actually surrendered and cancelled); Budd Int'l Corp. v. Commissioner, 45 B.T.A. 737 (1941) (loss allowed for entire basis), *rev'd on other grounds*, 143 F.2d 784 (3d Cir. 1944), *cert. denied*, 323 U.S. 802 (1945); Burdick v. Commissioner, 20 B.T.A. 742 (1930) (loss allowed for difference between basis in surrendered stock and enhanced value of retained stock), *aff'd*, 59 F.2d 395 (3d Cir. 1932); Wright v. Commissioner, 18 B.T.A. 471 (1929) (loss allowed on difference between

holder to deduct a loss because he has disposed of the transferred property and has received nothing taxable in return. That rationale could govern all the cases because for all shareholder contributions, the tangible benefits flow directly to the corporation, and the law does not ordinarily tax a shareholder on undistributed corporate benefits.[14]

In the third model, the *Downer*[15] or "constructive-sale" model, the shareholder is treated as having sold the contributed property for its fair market value. The rationale is that a rational shareholder must have anticipated benefits in return for the property contributed. The constructive sale mandates that the shareholder realize capital gain or loss if the fair market value of the property differs from its basis.[16] All the cases could be treated as constructive sales under this rationale because the shareholder's willingness to make the transfer indicates that he expects benefits equal in value to the property transferred.

Three inconsistent models, each applicable to the full range of nonprorata contributions, have led to inconsistent decisions on the same fact pattern[17] and to waivering among the models. The Tax

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fair market value of stock when surrendered and value on Mar. 1, 1913), *modified*, 47 F.2d 871 (7th Cir. 1931).

[14] *See, e.g.*, Scherman v. Helvering, 74 F.2d 742, 743 (2d Cir. 1935), quoted at *infra* text accompanying note 65.

[15] Downer v. Commissioner, 48 T.C. 86 (1967).

[16] *See* Wright v. Commissioner, 47 F.2d 871 (7th Cir. 1931) (loss on stock transfer to new corporate manager); Crow v. Commissioner, 29 T.C.M. (CCH) 1321 (1970) (alternative holding since net operating loss carryback denied in any event); Plumley v. Commissioner, 29 T.C.M. (CCH) 98 (1970) (loss disallowed because taxpayer's basis was equal to fair market value of transferred stock); Downer v. Commissioner, 48 T.C. 86 (1967) (loss on transfer of shares to employees); Sack v. Commissioner, 33 T.C. 805 (1960) (loss disallowed for lack of proof of value); Clement v. Commissioner, 30 B.T.A. 757 (1934) (same). *Cf.* Tilford v. Commissioner, 75 T.C. 134 (1980) (capital loss allowed on employee sale with loss measured by sale price), *rev'd*, 705 F.2d 828 (6th Cir. 1983) (no deduction allowed); Fred H. Lenway & Co. v. Commissioner, 69 T.C. 620 (1978) (transfer was a sale or exchange with zero amount realized), *aff'd*, 620 F.2d 310 (9th Cir. 1980). *See generally* United States v. Davis, 370 U.S. 65 (1962) (divorce-related transfer was sale or exchange with fair market value realized), discussed at *infra* notes 186-90 and accompanying text.

[17] Courts have allowed shareholders to deduct the cost of the stock transferred as compensation for services rendered to the corporation, *see* Northwest Motor Co. v. United States, 1960-2 U.S. Tax Cas. (CCH) ¶ 9488 (D.N.D. 1960) (100% shareholder); Burdick v. Commissioner, 20 B.T.A. 742 (1930), *aff'd*, 59 F.2d 395 (3d Cir. 1932) (loss adjusted to take account of shares later returned to corporation for cancellation) (50% shareholder), they have capitalized the shareholder's cost for the transferred stock, *see* Hewett v. Commissioner, 47 T.C. 483 (1967) (shares went to underwriter); Ames v. Commissioner, 14 B.T.A.

Court has changed its position eight times on the issue.[18] Even in the few times the court attempted to distinguish prior cases,[19] the proferred distinctions are not persuasive.[20] The existing commentary summarily rejects the soundest model.[21] It is time for a fresh

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1067 (1929), *aff'd,* 49 F.2d 853 (8th Cir. 1931)), and they have found that the shareholder had a constructive sale of the transferred stock. *See* Downer v. Commissioner, 48 T.C. 86 (1967); Sack v. Commissioner, 33 T.C. 805 (1960). All three models were applied by different judges to the facts in Wright v. Commissioner, 18 B.T.A. 471, 473-74 (1929) (majority applied the *Smith* model, dissent argued for the *Ames* model), *modified,* 47 F.2d 871, 872 (7th Cir. 1931) (circuit court applied the *Downer* model).

[18] *See* Ames v. Commissioner, 14 B.T.A. 1067 (1929), *aff'd,* 49 F.2d 853 (8th Cir. 1931) (minority shareholder's transfer of stock to corporate employee was a capital expenditure; no deduction allowed); Wright v. Commissioner, 18 B.T.A. 471 (1929) (nonprorata stock contribution for a new manager was a deductible loss of the stock's basis) (Change 1), *rev'd on this issue,* 47 F.2d 871 (7th Cir. 1931); Clement v. Commissioner, 30 B.T.A. 757 (1934) (contribution was sale for fair market value of the stock surrendered) (Change 2); Miller v. Commissioner, 45 B.T.A. 292 (1941) (ordinary loss of basis without realization of the value of the stock transferred) (Change 3); Sack v. Commissioner, 33 T.C. 805 (1960) (shareholder realized the fair value of the transferred property, thus no loss deduction) (Change 4); Duell v. Commissioner, 19 T.C.M. (CCH) 1381 (1960) (ordinary loss allowed) (Change 5); Downer v. Commissioner, 48 T.C. 86 (1967) (contribution was a sale or exchange, ordinary-loss cases not distinguished had been "washed away by the tides of more recent cases") (Change 6); Smith v. Commissioner, 66 T.C. 622 (1976) (ordinary loss allowed) (Change 7), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979); Tilford v. Commisssioner, 75 T.C. 134 (1980) (capital loss using the sale price instead of fair market value as the amount realized) (Change 8), *rev'd,* 705 F.2d 828 (6th Cir. 1983) . Throughout all the changes, the Tax Court held routinely and consistently that shareholders paying corporate expenses nonprorata are not entitled to deductions. *See, e.g.,* cases cited at Markwardt v. Commissioner, 64 T.C. 989, 995 (1975).

[19] *See* Smith v. Commissioner, 66 T.C. 622 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979); Downer v. Commissioner, 48 T.C. 86 (1967).

[20] In Downer v. Commissioner, 48 T.C. 86 (1967) (finding constructive sale) the court distinguished capitalized cash payments (*Ames* model), but noted that "one might question why there should be a different result simply because the subject matter of the transaction was stock of the corporation instead of cash." *Id.* at 90-91. *But see infra* text accompanying notes 128-30. The court also distinguished one case involving stock as involving the question of expenses and not loss. *See* 48 T.C. at 92 n.7. *But see infra* text accompanying notes 133-41. *Downer* distinguished some of the *Smith*-model cases as involving transfers to, rather than for, the benefit of the corporation, but granted that the "economic consequences may be essentially identical." 48 T.C. at 92. *But see infra* text accompanying notes 232-35. It dismissed other *Smith*-model cases as "washed away by the tides." 48 T.C. at 93.

In Smith v. Commissioner, 66 T.C. 622 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979), the court characterized *Downer* as involving benefits to the transferor and not just to the corporation, *see id.* at 649, whereas *Downer* had said that its situation was one where "all the transferor got was the hope and expectation that the employee would continue to work for the corporation." 48 T.C. at 92-93. *But see infra* text accompanying notes 117-21, 168-85.

[21] *See* Bolding, *supra* note 8, at 277 (courts have "declined to treat disproportionate stock surrenders as a contribution to capital"); Landis, *supra* note 8, at 266 (it "may be too late"

look at the issue.[22]

The thesis of this article is that the capitalization model is sound in law and reason and should be adopted by the courts for all nonprorata contributions. The ordinary-loss model is not tenable al-

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to argue for realization of neither gain nor loss); Manwell, *supra* note 8, at 275 (characterizes the issue as a question of the nature and extent of gain and loss); O'Brien, *supra* note 8, at 676 (a loss may be realized on a nonprorata contribution "although there are a number of old nonacquiescences outstanding"); Wagner, *supra* note 8, at 44 (courts have not adopted the capital contribution characterization); Wray, *supra* note 8, at 155 (contribution to capital is "against the weight of authority").

[22] Arguably, three models are too few to describe the decisions. Sometimes several rationales lead to the same basic result, yet different rationales should imply different borders between models. Within each of the models are several subcategories. Counting subcategories and arguments asserted in good faith, at least fourteen distinct categories exist, each with a reasonable common law basis. Four categories yield ordinary deductions, six categories yield capital losses, two categories yield capital gain and two others yield neither gain nor loss. The categories are as follows: (1) ordinary deduction of the basis of the transferred property, *see, e.g.*, Peabody Coal Co. v. United States, 8 F. Supp. 845 (Ct. Cl. 1934); (2) ordinary deduction of the basis reduced by the percentage of basis equal to the shareholder's post-transfer percentage of the corporation, *see, e.g.*, Burdick v. Commissioner, 20 B.T.A. 742 (1930), *aff'd*, 59 F.2d 395 (3d Cir. 1932); (3) ordinary deduction of the basis reduced by the amount by which the book value of the retained shares increases in the transaction, *see, e.g.*, Miller v. Commissioner, 45 B.T.A. 292 (1941); (4) ordinary deduction of the basis reduced by the percentage of value of property transferred equal to the shareholder's post-transfer percentage of the corporation, *see, e.g.*, Estate of Foster v. Commissioner, 9 T.C. 930 (1947); (5)-(8) same as (1)-(4) but allowing a capital loss rather than an ordinary deduction, *see, e.g.*, Arrowsmith v. Commissioner, 344 U.S. 6 (1952); Fred H. Lenway & Co. v. Commissioner, 69 T.C. 620 (1978), *aff'd*, 620 F.2d 310 (9th Cir. 1980); Granata v. Commissioner, 22 T.C.M. (CCH) 1627 (1963); (9) capital loss measured by the excess of the basis of the transferred property over its fair market value, *see, e.g.*, Wright v. Commissioner, 47 F.2d 871 (7th Cir. 1931); (10) capital loss computed with the value of the property as the amount realized and a deduction of the fair market value, *see, e.g.*, cases cited at *infra* note 98; (11) capital gain computed with the value of the property as the amount realized and a deduction of the fair market value, *see, e.g.*, cases cited at *infra* note 98; (12) capital gain measured by the excess of the fair market value over the basis, *see, e.g.*, Downer v. Commissioner, 48 T.C. 86 (1967); (13) nonrecognition of gain or loss with the shareholder adding the basis of the transferred property to the basis of his retained shares, *see, e.g.*, Ames v. Commissioner, 14 B.T.A. 1067 (1929), *aff'd*, 49 F.2d 853 (8th Cir. 1931); and (14) nonrecognition of gain or loss without the shareholder ever using the basis of the transferred property, *see, e.g.*, Arata v. Commissioner, 277 F.2d 576 (2d Cir. 1960); *cf.* Hoile v. Commissioner, 4 T.C.M. (CCH) 247, 253 (1945) (transfer to employer considered gift). For a discussion breaking down shareholder sales into eight categories (and up to three different characterizations into which a single sale may be fragmented), see Manwell, *supra* note 8, at 282-91.

In many of the models, it is not clear from the court's label how to treat the transferee or how to account for the shareholder's basis in his remaining shares. The three basic models, however, are adequate if one realizes that variations exist within them, that there are other less plausible possibilities, and that the models do not always settle the related consequences.

though it is certainly the one that the shareholder would prefer and is arguably the favorite of courts and commentators. The shareholder in reality makes a capital expenditure or investment when he makes a nonprorata contribution. Affording the shareholder an ordinary loss upon this investment seriously misaccounts for nonprorata contributions by allowing an immediate ordinary deduction for costs which generate future income, much of it capital gain. The capitalization model is correct whether the nonprorata contribution is in cash, unrelated property, or stock of the corporation, and whether the transfer is to the corporation or to a third party for the corporation's benefit.[23]

Part I of this article presents the three models the courts have used for nonprorata shareholder contributions and examines the history and rationales behind each model. Part II presents the arguments against the ordinary-loss model: the *Smith*-model courts' failure to address capitalization; the equivalence of "balanced" contributions and issues of new stock; and the economic inefficiency of encouraging inferior shareholder investments. Part III of the article addresses the constructive-sale model and analyzes the legal fiction that the shareholder receives something taxable in a nonprorata contribution. Part IV discusses the doctrines the courts have used instead of capitalization to reach the same result and concludes that the *Ames* model explains the results sufficiently without resort to those doctrines. The article concludes that the constructive-sale model has some theoretical appeal, but that only the *Ames* model will yield stable results consistent with principles of existing law and with the economic realities underlying the transfer.

I. History of the Models

A. *Model I: Capital expenditures—The* Ames *Line*

Under the *Ames* or capitalization model, a shareholder who makes a nonprorata contribution recognizes no gain or loss upon the transfer and increases the basis of his remaining shares by his basis in the property transferred. *Ames v. Commissioner*[24] was the earliest case involving a nonprorata contribution for the benefit of

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[23] *See supra* note 20.
[24] 14 B.T.A. 1067 (1929), *aff'd,* 49 F.2d 853 (8th Cir. 1931).

a corporation. In *Ames*, an estate transferred ten percent of its holdings in the American Law Book Company to certain corporate employees pursuant to a promise to make the transfer when the dividends of the company reached a defined level.[25] The court found that the promise had been "calculated to inspire the proposed beneficiaries with zeal, enthusiasm and industry in their work for the company."[26] The estate claimed a deduction for the value of the shares as a business expense,[27] but the Board of Tax Appeals rejected the claim:

> [The petitioner] was not in the law-book publishing business, except . . . as one of the joint owners of the stock. . . . Any additional profits . . . that resulted from increased efficiency of the benefited employees was not the income of the petitioner. We are of the opinion that the surrender of the stock . . . was a capital transaction designed . . . to increase the value of the stock remaining in the petitioner's hands rather than an expense incidental to the production of income in the taxable year 1922.[28]

In sum, the court found that the taxpayer had made a capital expenditure because the transfer did not relate to current income but was designed to enhance the value of his remaining shares.

Twice again in the year *Ames* was decided the Board required capitalization of nonprorata shareholder transfers. In *Vaughan v. Commissioner*,[29] a cashier's embezzlement of funds depleted the bank's surplus and impaired its capital.[30] The bank would have failed but for the transfer of securities worth $63,336 to the bank by the bank's president, a forty percent shareholder.[31] The shareholder claimed a loss for the value of his securities,[32] but the court rejected his claim:

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[25] *See* 14 B.T.A. at 1068. A syndicate of shareholders, of which the estate's decedent was a member, had promised the transfer. *See id.* The estate held a 30.5% interest in the syndicate. *Id.* The percentage held by the syndicate is not disclosed by the record, although it was apparently less than all of the outstanding shares. *See id.* at 1071.

[26] *Id.* at 1071.

[27] *See id.*

[28] *Id.* at 1072.

[29] 17 B.T.A. 620, *aff'g on reh'g* 15 B.T.A. 596 (1929).

[30] *See* 15 B.T.A. at 598.

[31] *See id.* at 597-98.

[32] *See id.* at 599-600. The Commissioner disallowed the deduction of the value of the stock, but allowed a loss deduction equal to the difference between its basis and the lower fair market value. *See* 17 B.T.A. at 620.

> This new investment can scarcely be termed a loss as the term is used in the revenue act, despite the compelling circumstances under which the funds were paid over to the corporation. While these funds left the hands of the petitioner, they went to enrich a corporation in which he was a substantial stockholder. Until the result of his investment in this stock is determined by a sale or liquidation of the corporation, it cannot be known whether there will be gain or loss.[33]

Similarly, in *Ward v. Commissioner*,[34] directors of a bank contributed cash and Liberty Bonds to replace worthless loans they had sponsored.[35] The court held that since the transfer was to protect the directors' investments, the shareholders sustained no loss.[36]

Ames, *Vaughan* and *Ward* have never been overruled, but subsequent cases involving nonprorata contributions ignore them. Although several subsequent decisions deny that a nonprorata contribution yields a deductible loss or constructive sale, the courts rely upon reasons other than capitalization and fail to cite the *Ames*-line cases.[37] Still *Ames* is not dead law, for "a case is not overruled by an omission to mention it."[38]

Apart from the *Ames*-line cases, general tax doctrines quite plausibly require capitalization of nonprorata shareholder contributions. The only rational motive for a shareholder's contribution is the desire to preserve his remaining investment in the corporation. That motive mandates capitalization: "Payments made by a stockholder of a corporation for the purpose of protecting his interest therein must be regarded as additional cost of his stock and such sums may not be deducted as ordinary and necessary [business] expenses."[39]

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[33] *Id.* at 622.

[34] 18 B.T.A. 326 (1929).

[35] *See id.* at 327.

[36] *See id.* at 328.

[37] *See, e.g.*, Fisher v. United States, 490 F.2d 218 (7th Cir. 1973) (shareholder cannot deduct stock transferred for the benefit of his corporation because he is not in the same business as the corporation); Hewett v. Commissioner, 47 T.C. 483 (1967) (same).

Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979), supports *Ames*, at least for contributions that are substantially pro rata. *See infra* text accompanying notes 87-94.

[38] United States v. Moreland, 258 U.S. 433, 436 (1922).

[39] Eskimo Pie Corp. v. Commissioner, 4 T.C. 669, 676 (1945), *aff'd per curiam*, 153 F.2d 301 (3d Cir. 1946). Some courts disallow a § 162 deduction of shareholder payments because

Similarly, the Supreme Court in its most recent articulation of the capitalization requirement held that an expenditure must be capitalized when the expense originated in a capital transaction.[40] This origin-of-the-claim test has been interpreted as a shift away from concern with subjective motive. For example, the Tax Court stated:

> It is apparent . . . that the origin-of-the-claim test will characterize an expense as a capital expenditure if such expense is incidental to either the purchase or sale of an asset or is made to protect one's interest in an asset, regardless of the taxpayer's motives in making such payment.[41]

While the use of the origin-of-the-claim test seems to have expanded the scope of capitalization,[42] nonprorata shareholder contributions should be treated as capital expenditures under either a "motive" or an "origin" test.

More fundamentally, a nonprorata contribution is an investment by the shareholder with respect to his stock. As with any stock investment, the shareholder's contribution is profit moti-

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they are more properly considered corporate expenses. *See, e.g.*, Atlantic Coast Line R.R. v. Commissioner, 81 F.2d 309, 311 (4th Cir.) (cost to parent corporation of guaranteeing dividends of wholly owned subsidiary), *cert. denied,* 298 U.S. 656 (1936); Markwardt v. Commissioner, 64 T.C. 989, 995-96 (1975) (cost of covenant not to compete with the corporation); Koree v. Commissioner, 40 T.C. 961, 965-66 (1963) (rent payments for wholly owned corporation); Ihrig v. Commissioner, 26 T.C. 73, 76 (1956) (payment of corporate operating expenses); Bavinger v. Commissioner, 22 B.T.A. 1239, 1240 (1931) (expense pursuant to endorsement of corporate note).

[40] *See* Woodward v. Commissioner, 397 U.S. 572, 577 (1970). The origin-of-the-claim test is supported by the Court's prior holding in Arrowsmith v. Commissioner, 344 U.S. 6 (1952), that the tax character of an expenditure is determined by the prior event to which it relates. *See, e.g.,* Siple v. Commissioner, 54 T.C. 1, 10-11 (1970); Schenk, Arrowsmith *and Its Progeny: Tax Characterization by Reference to Past Events,* 33 Rutgers L. Rev. 317, 343 (1981).

[41] Arthur H. DuGrenier, Inc. v. Commissioner, 58 T.C. 931, 938 (1972) (capitalizing a corporation's payments made to settle a dispute over the price the corporation had paid to redeem its stock).

[42] *See* Of Course, Inc. v. Commissioner, 499 F.2d 754, 756 (4th Cir. 1974) (citing Woodward v. Commissioner, 397 U.S. 572 (1970), and other authorities to overrule prior decisions allowing a deduction of § 337 expenses); Jim Walter Corp. v. United States, 498 F.2d 631, 638-39 (5th Cir. 1974) (capitalizing corporation's costs of redeeming shares in spite of prior authority allowing a deduction of redemption costs where purpose was to protect business); Vestal v. United States, 498 F.2d 487, 495 (8th Cir. 1974) (citing *Woodward* in capitalizing a fee for investment advice and distinguishing prior cases allowing a deduction); Helgerson v. United States, 426 F.2d 1293, 1298 (8th Cir. 1970) (holding that *Woodward* governs expenses of litigation to collect stock sale proceeds, notwithstanding prior cases allowing a deduction of the cost of collecting income).

vated—although the contributing shareholder receives no immediate return, he expects increased future dividends or greater proceeds from the sale of the stock. But in an income tax system, investments cannot be deducted when made. Both accounting[43] and tax[44] principles require capitalization of an expenditure which generates future income.

The future profits the shareholder seeks may not materialize, but that is true of all investments. In nonprorata contributions, the shareholder often initially loses value. Because he owns less than all the shares, his remaining shares do not immediately recapture the value of what he has contributed, and he will receive through his stock only part of the benefits the contribution generates for the corporation as a whole. But as long as the shareholder is willing to make the contribution, he must have expected his future returns to outweigh the initial loss of value.

B. *Model II: Ordinary Loss of Basis—The* Smith *Line*

The courts in the *Smith*-line cases hold that upon a nonprorata contribution the shareholder realizes a loss under the language of section 165(a) of the Internal Revenue Code: "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."[45] A loss under the *Smith* model is an ordinary loss because the *Smith* model does not treat the loss as resulting from a sale or exchange.[46]

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[43] *See* American Institute of Accountants, Accounting Terminology Bulletin No. 1, Review and Resume ¶ 26 (1953) (defining "asset"); De Capriles, *Modern Financial Accounting (Part 1),* 37 N.Y.U. L. Rev. 1001, 1020-21 (1962); National Association of Accountants, *Fixed Asset Accounting: The Capitalization of Costs,* 43 C.P.A. J. 193, 193-94 (1973).

[44] *See, e.g.,* NCNB Corp. v. United States, 651 F.2d 942 (4th Cir. 1981) (panel) (explaining tax theory of capitalization), *rev'd,* 684 F.2d 285 (4th Cir. 1981) (en banc) (capitalization is to be determined from " life in all its fullness"); Treas. Reg. § 1.461-1(a)(1) (expenditures with useful life extending substantially beyond the close of the taxable year are capitalized); Gunn, *The Requirement That a Capital Expenditure Create or Enhance an Asset,* 15 B.C.L. Rev. 443 (1974); Note, *Income Tax Accounting: Business Expense or Capital Outlay,* 47 Harv. L. Rev. 669 (1934).

[45] I.R.C. § 165(a). The predecessor of § 165(a) was enacted in the Corporate Income Tax Act of 1909, ch. 6, § 38, 36 Stat. 112 (1909): "Such net income shall be ascertained by deducting . . . all losses actually sustained within the year and not compensated by insurance or otherwise. . . ." *Id.* at 113.

[46] A shareholder contributing property with a basis exceeding its market value will also recognize a loss under the *Downer* or constructive-sale model, but the character of the loss will be capital if the property transferred is a capital asset. *See infra* text accompanying

The earliest cases allowing a deduction for a nonprorata contribution did so by contrasting a nonprorata contribution with a pro rata contribution. For example, in *Wright v. Commissioner*,[47] the first case in the line, the shareholders, in the aggregate, contributed fifty-one percent of their shares to compensate new management.[48] The corporation was in financial trouble and the corporation's bankers required the transfer of the shares.[49] The court held that the taxpayer could deduct the cost of his transferred shares:

> If the stock had been merely surrendered to the company so that the proportionate representation of stockholders remained the same, a different question would be presented,[50] but it is clear from the stipulated facts that such was not the case . . . and the petitioner definitely parted with [51 percent of his shares]. . . .

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notes 95-96.

[47] 18 B.T.A. 471 (1929), *modified*, 47 F.2d 871 (7th Cir. 1931).

[48] *See id.* at 472.

[49] *See id.*

[50] *Wright* and the cases cited at *infra* note 53 are progeny of Eisner v. Macomber, 252 U.S. 189 (1920). In *Macomber*, the Supreme Court held that a pro rata stock dividend constituted an insufficient change in the shareholder's position to be a realization of income within the Sixteenth Amendment's authorization to tax income. *See id.* at 211. In Scoville v. Commissioner, 18 B.T.A. 261 (1929), the Board of Tax Appeals applied the same theory against the taxpayer and held that a pro rata contribution of shares to the corporation was not an occasion for loss recognition. *See id.* at 264-65. *See also* Kistler v. Burnet, 58 F.2d 687 (D.C. Cir. 1932) (corporate reorganization), *aff'g* Fredericks v. Commissioner, 21 B.T.A. 433 (1930); Taylor v. MacLaughlin, 30 F. Supp. 19 (E.D. Pa. 1939) (pro rata surrender is not a sale but a readjustment of corporate financial position); Murphy v. Commissioner, 4 T.C.M. (CCH) 813 (1945) (prorata surrender to benefit corporate financial position); Bed Rock Petroleum Co. v. Commissioner, 29 B.T.A. 118 (1933) (pro rata surrender of stock to eliminate operating deficit). Where shares are surrendered pro rata and cancelled, all the shareholders of the corporation retain their prior ownership interest in the corporation; fewer certificates are outstanding after the contribution, but each shareholder maintains the same relative voting power and the same interest in dividends, assets and earnings. In a nonprorata contribution, however, the transferor has a real decline in his ownership interest and not a mere change in certificates or form of continued ownership. *See* Smith v. Commissioner, 66 T.C. 622, 647 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979); Duell v. Commissioner, 19 T.C.M. (CCH) 1381, 1384-85 (1960); Miller v. Commissioner, 45 B.T.A. 292, 299 (1941). *But see infra* notes 144-49.

The *Smith* model has never been applied where the property contributed is other than the stock of the benefited corporation. Perhaps this result arose because the *Smith* doctrine originated in *Macomber*. However, even contributions of stock of the benefited corporation have been capitalized, *see, e.g.*, Ames v. Commissioner, 14 B.T.A. 1067 (1929), *aff'd*, 49 F.2d 853 (8th Cir. 1931); *cf.* Fischer v. United States, 490 F.2d 218 (7th Cir. 1973), or held to be a constructive sale, *see, e.g.*, Wright v. Commissioner, 47 F.2d 871 (7th Cir. 1931); Downer v. Commissioner, 48 T.C. 86 (1967); Sack v. Commissioner, 33 T.C. 805 (1960).

> We are of [the] opinion petitioner is entitled to the loss claimed.[51]

The immediate deduction followed from the fact that a nonprorata contribution is a "definite parting" with the transferred property. The Board of Tax Appeals followed that rationale in two cases decided shortly after *Wright*[52] as did other courts in later cases.[53]

The Seventh Circuit reversed and remanded *Wright*,[54] however, and held that the contribution should be treated as though the transferor had sold the transferred stock for its fair market value.[55] The court stated that while the shareholder received no specific price for the shares, he received a "presently contemplated advantage": the corporation avoided bankruptcy and acquired both the continued support of its creditors and the services of the new manager.[56] According to the court, if the transferor had sold the stock he would have been entitled to a loss only of the difference between his basis in the stock and its lower fair market value.[57] The court therefore allowed a loss deduction for that amount.[58]

The Court of Claims and two circuit courts promptly rejected the *Wright* appeal and returned to allowing a deduction of the taxpayer's basis. The Court of Claims stated in *Peabody Coal Co. v. United States*:[59]

> We find ourselves unable to concur in basis of the measuring the loss sustained as thus announced by the [Seventh Circuit in *Wright*]. Had the stock in question been sold and money or other property of a determinative value been received therefor, the difference between the cost and such consideration would, of course, have been the taxpayer's deductible loss. But Wright, as the plaintiff in the case at bar, received at the time nothing whatever for

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[51] 18 B.T.A. at 472-73.

[52] *See* City Builders Fin. Co. v. Commissioner, 21 B.T.A. 800 (1930) (relying on *Wright* as dispositive); Burdick v. Commissioner, 20 B.T.A. 742 (1930) (in transfering shares to hire new management, the shareholder just transferred a part of what he formerly owned), *aff'd*, 59 F.2d 395 (3d Cir. 1932).

[53] *See* Smith v. Commissioner, 66 T.C. 622, 647 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979); Duell v. Commissioner, 19 T.C.M. (CCH) 1381, 1384-85 (1960); Miller v. Commissioner, 45 B.T.A. 292, 299 (1941).

[54] Wright v. Commissioner, 47 F.2d 871 (7th Cir. 1931), *rev'g* 18 B.T.A. 471 (1929).

[55] *Id.* at 872.

[56] *Id.*

[57] *See id.*

[58] *See id.*

[59] 8 F. Supp. 845 (Ct. Cl. 1934).

> the stock surrendered and should not, therefore, we think, be charged with whatever market value the stock may have had which he did not, at the time, receive. That market value belonged to the persons who received the stock. . . . Any increase in the market value of the stock of the corporation . . . several years after the transaction, if the affairs of the corporation were subsequently successful, cannot affect the question here.[60]

The two circuit courts seem to have adopted the same argument. In *Burdick v. Commissioner*[61] the Third Circuit stated: "The real and only consideration [the shareholder] received was the expectation that under the [new] management the retained stock of the taxpayer would have an enhanced value."[62] In 1935, the Second Circuit, speaking through Judge Learned Hand in *Scherman v. Helvering,*[63] agreed and added to the debate an argument that the shareholder must be allowed a loss upon the transfer to properly account for his costs.[64] While the court found that the shareholder's shares might rise in value and that dividends might increase as a result of the transfer of shares to an employee, the court continued:

> [N]one of these increments in value were present "property"; certainly not the undeclared dividends, equally not the increase in value of the shares, until they were sold.
>
> This last consideration also shows the injustice of disallowing the loss at the present time: it is now or never. If [the employee's] accession did turn out to be as profitable as [the shareholders] expected, there would be larger dividends if the shares were kept, and a higher sale price if they were sold. But the shareholders could not set off this loss—for there surely was a loss de facto—against either of these. . . . [I]f [the shareholder] is to be charged with the profits—as he will be—he ought to be allowed to deduct what [the shares] have cost him.[65]

Although the Board of Tax Appeals followed the constructive-

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[60] *Id.* at 848.

[61] 59 F.2d 395 (3d Cir. 1932), *aff'g* 20 B.T.A. 742 (1930).

[62] *Id.*

[63] 74 F.2d 742 (2d Cir. 1935).

[64] *See id.* at 743.

[65] *Id. See* Kress v. Stanton, 98 F. Supp. 470, 476 (W.D. Pa. 1951), *aff'd per curiam,* 196 F.2d 499 (3d Cir. 1952); *see also* Berner v. United States, 282 F.2d 720, 727 (Ct. Cl. 1960).

sale model shortly after the Seventh Circuit's *Wright* decision,[66] after *Peabody Coal, Burdick* and *Scherman* the Board returned to allowing deduction of basis.[67] For the *Smith*-line cases prior to 1941, it arguably was irrelevant whether the loss was capital or ordinary, but by the time the Board of Tax Appeals readopted its *Wright* decision over the Seventh Circuit's appellate decision, capital losses were not deductible in full against ordinary income.[68] In *Budd International Corp. v. Commissioner,*[69] the Board used its rejection of the *Wright* appeal to determine that the loss was ordinary and not capital:

> There is nothing in the circumstances of the disposition of petitioner's shares to give color to the idea that there was a sale or exchange. Petitioner received nothing, unless it be the possible effect upon its remaining shares. What the effect was, does not appear; but there was nothing more tangible. [Petitioner] merely gave up its shares . . . and received nothing. Since a taxpayer bondholder receiving money on redemption is held not to have disposed of his bond by sale or exchange, it is impossible consistently to say that a shareholder who surrenders his shares for no money, property, or rights is making a sale or exchange.[70]

Under the court's reasoning, the ordinary character of the loss fol-

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[66] *See* Clement v. Commissioner, 30 B.T.A. 757 (1934).

[67] *See* Budd Int'l Corp. v. Commissioner, 45 B.T.A. 737 (1941) (pro rata transfer), *rev'd on other grounds,* 143 F.2d 784 (3d Cir. 1944), *cert. denied,* 323 U.S. 802 (1945); Miller v. Commissioner, 45 B.T.A. 292 (1941) (nonprorata transfer).

[68] In Downer v. Commissioner, 48 T.C. 86 (1967), the Tax Court questioned the continued validity of *Peabody Coal* in part because *Peabody Coal* purportedly allowed ordinary losses before the limitations on capital losses were enacted. *See id.* at 92. At the time of the early decisions, capital losses were, at least in some situations, treated less favorably than ordinary losses. However, it is not clear in every case how the taxpayers were affected. Both *Peabody Coal* and *City Builders* involved the corporate income tax for 1925, a year in which both corporate capital losses and corporate ordinary deductions yielded tax savings of 12½%. *See* Revenue Act of 1924, ch. 234, § 208(c), 43 Stat. 253, 263. *Burdick* and *Wright* involved individual tax for 1922 and 1923 when capital loss was netted against capital gain, if the taxpayer had any, but was otherwise treated as an ordinary deduction. Revenue Act of 1921, ch. 136, §§ 206(a)(4)-(5), (c), 42 Stat. 227, 233. In 1934, Congress limited the capital loss deduction to $2000 annually and allowed a deduction of only a percentage of capital losses. *See* Revenue Act of 1934, ch. 277, §§ 23(j), 117(d), 48 Stat. 680, 689, 715. The taxpayer thus had to determine the character of a loss for tax years after 1934.

[69] 45 B.T.A. 737 (1941).

[70] *Id.* at 756. *But see* Fred H. Lenway & Co. v. Commissioner, 69 T.C. 620 (1978) (zero amount realized but loss is capital loss); *accord* Granata v. Commissioner, 22 T.C.M. (CCH) 1627 (1963).

lowed from the conclusion that the contribution was not a sale or exchange.[71]

Although the *Smith* line thrived by rejecting the constructive-sale model, the next new argument in the *Smith* model arose from a constructive-sale case. In *Downer v. Commissioner*,[72] the Tax Court, relying in part on the *Wright* appeal, held that a nonprorata transfer should be taxed as if it were a sale or exchange.[73] While a loss from a sale or exchange is quite different from a *Smith*-doctrine ordinary loss, the two models share the characteristic that the transfer is an event upon which a loss may be recognized. When the *Downer* court, as a first step in its analysis, decided that a contribution was properly an event for loss recognition, the court employed language which was later used to support the *Smith* line. The *Downer* court, after admitting that nonprorata cash contributions are capitalized with no immediate tax consequence,[74] proceeded to distinguish a stock contribution because stock is "fragmented":

> [T]he evolution of the statutory and decisional framework had been on a fragmented, i.e., share by share, rather than a unitary view of a shareholder's investment. Thus, for example, a shareholder who sells a portion of his shares realizes taxable gain or loss measured by the difference between amount received and his cost basis in those shares even though dollarwise the transaction does not recoup his total investment.
>
> Once the fragmented view is accepted—as we think it must be—it is possible to draw a distinction between the situation where

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[71] *See* 45 B.T.A. at 756. *See also* Kress v. Stanton, 98 F. Supp. 470, 476 (W.D. Pa. 1951), *aff'd per curiam*, 196 F.2d 499 (3d Cir. 1952); Smith v. Commissioner, 66 T.C. 622, 648-49 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979).

The *Smith* courts have also allowed an ordinary loss where a shareholder sells stock to an employee at a bargain if the loss arises from the bargain. *See, e.g.*, Berner v. United States, 282 F.2d 720 (Ct. Cl. 1960). Arguably the deduction follows naturally from the premise underlying the entire *Smith* model that the transferred property is disposed of in a nonprorata contribution and nothing is received for the bargain. The deduction for the bargain nevertheless requires disregarding that the shareholder's loss was realized in a sale or exchange to the employee.

[72] 48 T.C. 86 (1967).

[73] *See id.* at 93.

[74] *Id.* at 90-91 (citing Eskimo Pie Corp. v. Commissioner, 4 T.C. 669, 676 (1945), *aff'd per curiam*, 153 F.2d 301 (3d Cir. 1946)). The court itself questioned why a different result should apply simply because stock rather than cash was transferred. *See id.* at 90. *See also infra* notes 129-30 and accompanying text.

> a shareholder transfers cash and where he transfers part of his shares to a third party. In the former case, there is no change in his proportionate shareholder interest in the corporation—only his investment has been varied [citations omitted] [and the transfer of cash for the benefit of the corporation only increases the shareholder's basis in the stock]. In the latter case, such a change admittedly takes place.[75]

In *Smith v. Commissioner*,[76] the most recent case allowing an ordinary loss, the Tax Court cited the quoted language to support the recognition of an ordinary loss[77] even though the court had to distinguish *Downer* to find that the loss was ordinary.[78] In *Smith*, two shareholders, Smith and Schleppy, who together owned seventy percent of the corporation, transferred seven percent of their shares (five percent of the outstanding stock) to the corporation.[79] The corporation had settled a dispute with its major creditor by increasing the ratio at which the creditor could convert the corporation's debt into stock.[80] Before the transfer, the corporation did not possess sufficient treasury stock to satisfy the potential conversion at the increased ratio.[81] Smith and Schleppy testified that they transferred the stock to enable the corporation to convert the creditor's debt because they feared liability to minority shareholders for their actions in the settlement.[82] Since the transfer reduced the outstanding shares of the corporation, Smith and Schleppy's combined fractional interest in the corporation decreased from seventy percent to just over sixty-eight percent.[83] The shareholders' primary contention was that they were entitled to a business expense deduction for the transfer measured by the fair market value of $4 per share.[84] While the court denied the $4 per share deduc-

[75] 48 T.C. at 91.

[76] 66 T.C. 622 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979).

[77] *See* 66 T.C. at 647 n.5. *See also* Schleppy v. Commissioner, 601 F.2d at 197.

[78] *See* 66 T.C. at 649.

[79] *See id.* at 636.

[80] *See id.* at 633-36.

[81] *See id.* at 642-43.

[82] *See id.* The shares were held as treasury stock for the possible conversion, but the conversion never occurred. *See id.* at 637.

[83] *See id.* at 648.

[84] *See id.* at 639-41, 645.

tion,[85] it did allow a relatively small loss deduction under section 165 for the shareholder's basis in the transferred shares—twenty-three cents per share.[86]

The Fifth Circuit reversed *Smith* in *Schleppy v. Commissioner* and disallowed any loss.[87] Construed broadly, the Fifth Circuit's decision could be interpreted as re-establishing the *Ames* model in the area of nonprorata contributions. It relied on *Estate of Foster v. Commissioner,*[88] citing it, quite erroneously, for the proposition that the shareholders' basis in the surrendered shares had to be added to their basis in the remaining shares.[89] Under the court's reading of *Foster,* there was no need to draw a troublesome distinction between a shareholder's cash contributions, which are capitalized, and stock contributions.[90] Certainly *Schleppy* indicates judicial restlessness with the *Smith* model.

Strictly speaking, however, *Schleppy* leaves the *Smith* model intact where the contribution is substantially nonprorata. *Schleppy* distinguished *Downer* as requiring recognition of loss where "[a]s a result of the transaction Downer had substantially less stock in the corporation than he previously [had owned]."[91] The shareholders' ownership in *Downer* decreased from 66.67 percent of the shares to just over 50 percent, whereas Smith and Schleppy's ownership only

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[85] The court held that the expense was not related to the shareholders' own business. *See id.* at 647.

[86] *See id.* at 650.

[87] Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979), *rev'g* Smith v. Commissioner, 66 T.C. 622 (1976). The court stated that it found no court of appeals decision that determined the correctness of *Smith* and that it was writing on a clean slate. *See id.* at 198. However, several appellate decisions had previously supported *Smith, see* Kress v. Stanton, 196 F.2d 499 (3d Cir. 1952) (per curiam); Scherman v. Helvering, 74 F.2d 742 (2d Cir. 1935); Burdick v. Commissioner, 59 F.2d 395 (3d Cir. 1932), and several conflicted with *Smith, see* Fischer v. United States, 490 F.2d 218 (7th Cir. 1973) (capitalization); Ames v. Commissioner, 49 F.2d 853 (8th Cir. 1931) (same); Wright v. Commissioner, 47 F.2d 871 (7th Cir. 1931) (constructive sale).

[88] 9 T.C. 930 (1947).

[89] *See* 601 F.2d at 198. *Foster,* in fact, allowed an ordinary loss for shares contributed and cancelled, *see* 9 T.C. at 937-38, and Smith and Schleppy's shares were ultimately cancelled. *See Smith,* 66 T.C. at 637-38. *Foster* does deny a loss for stock sold by the corporation after the contribution if the contributing shareholder's fractional interest in the proceeds exceeds the basis transferred. *See infra* note 94. *Foster,* like *Ames,* adds the shareholder's basis in the transferred property to his basis in the retained shares if no loss is allowed on the transfer. *See* 9 T.C. at 937.

[90] 601 F.2d at 197 (citing Eskimo Pie Corp. v. Commissioner, 4 T.C. 669 (1945), *aff'd per curiam,* 153 F.2d 301 (3d Cir. 1946)), quoted at *supra* text accompanying note 39.

[91] 601 F.2d at 198.

decreased from 70.12 percent to 68.57 percent.[92] The courts had previously held that stock redemptions which departed only insignificantly from pro rata would be treated as pro rata.[93] After *Schleppy,* one could expect redemption cases to be used as precedents in the area of contributions. Thus, in the future, a nonprorata contribution will probably have to effect a "meaningful reduction of the shareholder's proportionate interest" to come within the *Smith* model.[94]

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[92] *See id.*

[93] *See* Murphy v. Commissioner, 4 T.C.M. (CCH) 813, 814 (1945); Cohen, Surrey, Tarleau & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders,* 52 Colum. L. Rev. 1, 33 (1952) (the pro rata criterion cannot be applied rigidly to redemptions or "slight variations in proportionate interests would become the fashion").

The tax treatment of stock redemptions similarly depends upon whether they are pro rata or "substantially disproportionate." *See* I.R.C. § 302(b)(2). As in § 302, the purpose of the test under the *Smith* model is to determine whether the shareholder's disposition of stock is a change in substance or merely a change in form.

[94] United States v. Davis, 397 U.S. 301, 313 (1970). The transfers in Scherman v. Helvering, 74 F.2d 742 (2d Cir. 1935) (5% decline in interest) and Kress v. Stanton, 98 F. Supp. 470 (W.D. Pa. 1951) (17% decline), *aff'd per curiam,* 196 F.2d 499 (3d Cir. 1952), would similarly not be substantially nonprorata under current redemption tests. If the court had adopted from § 351 the standard of what constitutes a mere change in form, then Smith and Schleppy would have passed the test. Section 351 treats a contribution as a mere change in form only if the transferors own 80% of the shares after the transfer. *See* I.R.C. § 351. Smith and Schleppy owned only 69% after the transfer. *See* 601 F.2d at 198.

The Fifth Circuit's opinion also expressed doubt that a loss had occurred. *See id.* at 198-99. If the creditor exercised its conversion right, Schleppy and Smith's interest in the conversion price, through their retained shares, would have exceeded their basis. *See id.* at 198. In that case, they would have been entitled to no loss. *See id.* The Fifth Circuit's language unintentionally left open the possibility that Smith and Schleppy would be entitled to some ordinary loss when their transferred shares were ultimately cancelled. *See id.* at 198-99.

The measurement of the shareholder's loss within the *Smith* model has varied. Section 165 limits the loss to the basis of the transferred shares, *see* I.R.C. § 165(b), and every *Smith* case refuses to measure loss as if the transfer were a sale for fair market value. Some *Smith* cases recognize that the shareholder has not lost his full basis in the contributed stock because he continues to own some shares. For example, if the corporation cancels the contributed stock, the remaining shares will represent a greater fraction of the ownership of the corporation. In that case, the *Smith* courts reduce the shareholder's ordinary loss to reflect the interest recaptured by the retained shares. Since the *Smith* line grew out of the juxtaposition of losing contributions and pro rata contributions which involve no reduction in interest, the reduction seems natural. However, the measurement of the adjustment has varied from Burdick v. Commissioner, 20 B.T.A. 742 (1930), *aff'd,* 59 F.2d 395 (3d Cir. 1932), where the court adjusted the loss by the percentage of the basis of the transferred stock equal to the fraction of the corporation represented by the shareholder's retained shares, to Payne Housing Corp. v. Commissioner, 13 T.C.M. (CCH) 603 (1954), and Miller v. Commissioner, 45 B.T.A. 292 (1941), where the courts made the adjustments according to the increase in the book value of the retained shares, to Duell v. Commissioner, 19 T.C.M.

C. *Model III: Constructive Sale—The* Downer *Model*

The constructive-sale model treats the taxpayer as if he sold the property and realized an amount equal to its fair market value. Under section 1001(a), gain or loss on the transfer is calculated by subtracting the taxpayer's adjusted basis in the transferred property from the property's value at the time of the transfer.[95] Because the gain or loss is treated as arising on a sale or exchange, the gain or loss is capital if the property transferred is a capital asset.[96] The Supreme Court has found constructive sales where a husband transferred appreciated property in a divorce settlement[97] and where an employer used appreciated property to compensate employees.[98] The first constructive sale, however, arose from a

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(CCH) 1381 (1960), and Estate of Foster v. Commissioner, 9 T.C. 930 (1947), where the courts measured the adjustment with reference to book value, but used language which indicates that the adjustment should be the increase in the true value of the retained shares.

The courts should use the real value recaptured through retained shares to adjust the loss, instead of cash or book value. The harm in using book value is illustrated by Northwest Motor Serv. Co. v. United States, 1960-2 U.S. Tax Cas. (CCH) ¶ 9488 (D.N.D. 1960), where the stock of the company apparently had no book value because no earnings were retained, but had considerable real value. *See id.*

Where the transfer is to or for an outsider and the outsider pays no tangible consideration for the shares, the *Smith* line has generally allowed a deduction of the full basis in the transferred property. *See, e.g., id.* (compensation to new president); Peabody Coal Co. v. United States, 8 F. Supp. 845 (Ct. Cl. 1934) (transfer to induce loan to corporation); Budd Int'l Corp. v. Commissioner, 45 B.T.A. at 737 (transfer to creditor to induce loan); City Builders Fin. Co. v. Commissioner, 21 B.T.A. at 800 (transfer to bankers who in turn compensated new president). Because those courts have ignored any intangible consideration received by the shareholder in allowing the loss, allowing a deduction for the full basis seems consistent.

Allowing less than the transferor's full basis does not transform the loss into a capital loss. For example, an insurance reimbursement for a portion of a casualty loss does not make the remainder a loss from sale or exchange. Moreover, when a shareholder's remaining shares increase in value because of his contribution, the increase is more like appreciation in an asset he already owns than it is the amount realized in a sale or exchange.

Under Estate of Foster v. Commissioner, any basis not recognized as a loss under the *Smith* model when the contribution is made is added to the shareholder's basis for his retained shares. *See* 9 T.C. at 937.

[95] *See* I.R.C. § 1001(a).

[96] *See id.* § 1222.

[97] United States v. Davis, 370 U.S. 65, 72-73 (1962).

[98] *See* Riley v. Commissioner, 328 F.2d 428 (5th Cir. 1964), *aff'g per curiam* 37 T.C. 932 (1963); United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960); International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1934); Tasty Baking Co. v. United States, 393 F.2d 992 (Ct. Cl. 1968); A.P. Smith Mfg. Co. v. United States, 364 F.2d 831 (Ct. Cl. 1966), *cert. denied,* 385 U.S. 1003 (1967); Simonson v. Commissioner, 34 T.C.M. (CCH) 47 (1975); McDougal v. Commissioner, 62 T.C. 720, 726 (1974); Treas. Reg. § 1.83-6(b)

nonprorata shareholder contribution.

The first constructive-sale case was the Seventh Circuit's reversal of *Wright*,[99] the earliest decision in the *Smith* line.[100] The Seventh Circuit found a constructive sale of the transferred stock where a shareholder, under pressure from his corporation's bankers, surrendered stock for his company to transfer to new managers.[101] The court allowed the taxpayer a loss equal to the difference between the fair market value of the stock transferred and his basis in that stock:

> If the taxpayer, instead of surrendering the stock, had then sold it at, say, 20, he would have been entitled to a loss deduction of the difference between 20 and its [basis]. . . . While by the transaction of surrender the taxpayer did not realize a specific price for the stock, he did realize a presently contemplated advantage to the corporation—and indirectly to himself—consisting of the managerial service of the manager for whom the stock was surrendered and the averting of threatened bankruptcy of the corporation, as well as the further support of the bankers.
>
> . . .
>
> We believe that for the purposes of taxation the fair market value of the stock at the time of surrender may properly be regarded as the price realized for it by the taxpayer in the form of contemplated advantage.[102]

(1978); Rev. Rul. 73-34, 1973-2 C.B. 11; Rev. Rul. 69-181, 1969-1 C.B. 196.

[99] Commissioner v. Wright, 47 F.2d 871 (7th Cir. 1931). The Seventh Circuit remanded the case to receive evidence of the stock's value. *See id* at 872.

[100] *See supra* text accompanying note 47.

[101] *See supra* notes 47-58 and accompanying text.

[102] 47 F.2d at 872. The Seventh Circuit's decision is probably best understood as addressing solely the issue of when costs may be deducted and not whether the loss is ordinary or capital. In the year *Wright* addressed, capital losses were netted against capital gains, whereas ordinary losses were not, but net capital loss was treated the same as ordinary loss. *See* Revenue Act of 1921, ch. 136, § 206(a)(2)-(4), (c), 42 Stat. 227, 232-33 (effective for sales in 1922 and thereafter). Neither the Circuit Court nor Board of Tax Appeals mentioned whether the taxpayer had net capital gains from some unrelated source.

On the timing issue, the *Wright* decision arguably represented a compromise between the majority and dissenting opinion below. The majority of the Board had allowed the transferring shareholders to deduct the full basis of the shares surrendered to the corporation. *See supra* text accompanying note 51. Judge Murdock's dissenting opinion would have allowed the shareholders no deduction because one could not tell whether the whole transaction was a gain or loss until the shareholders sold their remaining shares. *See* 18 B.T.A. at 473, quoted at *infra* text accompanying note 135. The Seventh Circuit allowed some deduction upon contribution, but not a deduction of the entire basis of the transferred stock. *See* 47 F.2d at 872.

The constructive-sale doctrine was followed three years after *Wright* in *Clement v. Commissioner*,[103] but thereafter it fell into disuse. As previously noted, the Court of Claims and two circuit courts rejected the reasoning in *Wright* that a nonprorata contribution was a sale.[104] The Board of Tax Appeals followed suit and treated the loss as ordinary.[105] In 1960 the Tax Court used the constructive-sale model to deny ordinary-loss treatment,[106] but the decision did not cite any of the prior cases that had rejected the *Smith* doctrine. Constructive sales, however, were revived for nonprorata contributions after more careful consideration by the Tax Court in *Downer v. Commissioner*.[107]

In *Downer,* a sixty-six percent shareholder reduced his interest in the corporation to just over fifty percent by transferring the difference (approximately a sixth of the outstanding shares) to an officer of his corporation.[108] The corporation, a manufacturer of private airplanes, desperately needed working capital to continue operations.[109] While the officer had originally been hired to market airplanes, at the time of the transfer he was attempting to raise the needed capital.[110] The court held that the shareholder constructively sold the stock to the officer and realized its fair value[111] even though he received no tangible consideration in return:

> Petitioner does not deny the fact that he transferred his shares to [the officer] in the hope and expectation that the latter would help in the negotiations [to obtain more working capital] and would continue to work for the corporation. The shares were the not-so-hidden persuader to these ends. . . . Admittedly, the benefits might not materialize and admittedly petitioner had no legal claim

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[103] 30 B.T.A. 757 (1934), discussed at *infra* text accompanying notes 170-75.

[104] *See supra* notes 59-65 and accompanying text.

[105] *See supra* notes 67-71 and accompanying text.

[106] *See* Sack v. Commissioner, 33 T.C. 805 (1960), discussed at *infra* text accompanying notes 176-79.

[107] 48 T.C. 86 (1967).

[108] *See id.* at 88.

[109] *See id.* at 86.

[110] *See id.* at 87.

[111] In *Downer,* stock had recently been sold at a price in excess of Downer's basis. *See id.* at 88-89. Downer would have had a gain on his transfer if the court had used those sales to determine the shares' value. The court, however, decided that the sales were too isolated and involved buyers too unsophisticated to be helpful. *See id.* at 94. Therefore, the court gave the shareholder a capital loss of the difference between his $1 per share basis and 15¢ per share, the value the court determined he received for his transfer. *See id.* at 94-95.

on [the officer], but such considerations have not prevented the finding of a "sale or exchange."[112]

The *Downer* court stated that the efficacy of the *Smith*-line ordinary-loss cases "has been washed away by the tides of more recent decisions,"[113] and distinguished the *Smith*-line cases that were transfers to the corporation and not to third parties.[114] The court also distinguished cases holding that cash contributions are capitalized by arguing that stock is "fragmented."[115]

Downer could have been used to reject the ordinary-loss model.[116] In *Smith,* however, the Tax Court distinguished *Downer* and allowed an ordinary loss: "[In *Downer*] the consideration for the transfer flowing from the transferee of the stock to the transferor was clear. Here the results of the transfer of the stock . . . to the corporation were to benefit the corporation by facilitating its entering into an agreement beneficial to it."[117] Why that language distinguishes *Downer* is unclear. Like Smith, Downer was a shareholder attempting to facilitate an arrangement beneficial to his corporation and Downer, like Smith, could achieve a tangible return only through his shares. The *Smith* court could have used a distinction that *Downer* invited. *Downer* avoided prior ordinary-loss cases by distinguishing between transfers to outsiders and transfers to the corporation, requiring a constructive sale upon the transfer to outsiders.[118] *Smith,* however, involved a transfer to the corporation and thus the court could have allowed an ordinary de-

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[112] *Id.* at 92-93.

[113] *Id.* at 94. *Downer* also questioned some of the *Smith*-line cases, stating that they were decided before capital losses were limited. *See id.* at 92. *But see supra* note 68 and accompanying text.

[114] 48 T.C. at 92. *But cf. infra* text accompanying notes 232-35. One commentator is especially critical of *Downer*'s mischaracterization of the facts of *Budd Int'l Corp.* where the *Downer* court stated that the shareholder in *Budd* did not contemplate a transfer to outsiders. *See* Manwell, *supra* note 8, at 281-82. *Compare Budd Int'l Corp.,* 45 B.T.A. at 737 *with Downer,* 48 T.C. at 92 n.10.

Prior to *Downer,* transfers directly to outsiders were taxed more advantageously than transfers to the corporation—the full basis was deducted upon transfers to outsiders, but only part of the basis was deducted upon transfers to the corporation. *See supra* note 94. *Downer* thus eliminated the relative advantage of a distribution to an outsider.

[115] 48 T.C. at 90-91, quoted at *supra* text accompanying note 75. *See also infra* text accompanying notes 129-30.

[116] *See, e.g.,* Plumley v. Commissioner, 29 T.C.M. (CCH) 98 (1970).

[117] *Smith,* 66 T.C. at 649.

[118] *See supra* note 114 and accompanying text.

duction by the *Downer* distinction.[119] The Tax Court, however, subsequently used *Downer* on the wrong side of the distinction.[120] Ultimately, a distinction between a transfer to a corporation and a transfer for the benefit of a corporation makes no sense.[121] Still, if *Smith* is not distinguishable from *Downer,* then the border between the ordinary-loss and the constructive-sale models is not predictable.

II. CRITIQUE OF THE *Smith* Model

While the courts have applied the ordinary-loss model to nonprorata contributions, the model is inappropriate to the cases. First, the *Smith*-model courts have never considered the capitalization requirement. "Capital expenditure" describes the facts more appropriately than does "ordinary loss." Second, the courts have not considered the economic equivalence of "balanced" contributions and new issues of stock. Finally, the *Smith*-model courts have not recognized that allowing an ordinary-loss deduction encourages shareholders to make inferior investments.

A. *Capital Expenditures and Ordinary Losses*

The major arguments relied on by the *Smith* courts are that the transferor has made a real disposition of his ownership interest in the corporation[122] and received nothing taxable in return,[123] that stock is fragmented,[124] and that allowing a loss is necessary for the

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[119] *See supra* text accompanying notes 76-86. The irony is that prior to *Downer,* transfers to the corporation were treated less beneficially. *See supra* note 94.

[120] In Fred H. Lenway & Co. v. Commissioner, 69 T.C. 620 (1978), *aff'd per curiam,* 620 F.2d 310 (9th Cir. 1980), the Tax Court cited *Downer* in holding that a shareholder's surrender of shares to the corporation was a capital loss. *See* 69 T.C. at 628-29. The court said that the benefits inuring to the shareholder in *Lenway* were "much more distinct and capable of measurement" than those to the taxpayer in *Smith,* and that therefore the court need not elaborate on the distinction between transfers to or for the benefit of the corporation. *Id.* at 628.

[121] *See infra* text accompanying notes 232-35.

[122] *See* Wright v. Commissioner, 18 B.T.A. 471, 473 (1929), *modified,* 47 F.2d 871 (7th Cir. 1931), quoted at *supra* text accompanying note 51. *See also supra* notes 52-53 and accompanying text.

[123] *See, e.g.,* Peabody Coal Co. v. United States, 8 F. Supp. 845, 848 (Ct. Cl. 1934), quoted at *supra* text accompanying note 60. *See also supra* text accompanying notes 62, 65, 70, 71.

[124] *See supra* text accompanying notes 75-78.

shareholder to recover his costs.[125] The *Smith*-line cases have never considered whether a nonprorata contribution is a capital expenditure. A capital expenditure is inconsistent with ordinary loss. Each argument behind the *Smith* line fails to rebut capital expenditure treatment, and some arguments in fact support it.

The first argument, that the shareholder has made a "real disposition" of stock, does not mandate ordinary-loss treatment. A capital expenditure is defined in part as "[a]ny amount paid . . . to increase the value of any property or estate."[126] That definition encompasses payments made with property even where the shareholder clearly terminates his interest in the property transferred. A complete transfer of the property may mean that the contribution was a real expenditure, but it does not follow that the expenditure was a current expense.

The argument that the absence of a current taxable return to the taxpayer requires ordinary-loss treatment is also without merit. The absence of a current return in fact supports capital treatment because a capital expenditure by definition is an investment attributable to future, rather than current, income.[127] Nonprorata cash payments to or for the corporation would be capitalized without dispute,[128] but the shareholder receives no more in exchange for a cash contribution than he does for a stock contribution.

Smith asserts a distinction between cash contributions and stock contributions because stock is "fragmented"—the sale of a single share can yield taxable gain or loss even if the shareholder has not disposed of his entire interest in the corporation.[129] The concept of fragmentation, however, fails to establish any distinction between cash and stock. Each dollar is separate enough from other dollars

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[125] *See* Scherman v. Helvering, 74 F.2d 742, 743 (2d Cir. 1935), quoted at *supra* text accompanying note 65.

[126] I.R.C. § 263(a)(1).

[127] *See supra* notes 43-44 and accompanying text.

[128] *See* Deputy v. Du Pont, 308 U.S. 488 (1940) (16% shareholder paid corporate compensation expense); Rand v. Commissioner, 35 T.C. 956 (1961) (33% shareholder paid corporate compensation expense); Ihrig v. Commissioner, 26 T.C. 73 (1956) (50% shareholder paid corporate operating expense); Balsam Estate v. Commissioner, 3 T.C.M. (CCH) 1204 (1944) (25% shareholder paid salaries of corporate consultants); Bavinger v. Commissioner, 22 B.T.A. 1239 (1931) (participating shareholders owning "large part" paid note endorsed by the corporation). *See also* Commissioner v. Tellier, 383 U.S. 687 (1966) (function of term "ordinary" is to distinguish between capital expenditures and current expenses).

[129] *See supra* text accompanying notes 75-78.

for the disposition of a single dollar to have tax consequences. A tax system in which all of a taxpayer's dollars are considered so unitary that no tax consequences could arise unless the taxpayer had disposed of all of his cash is inconceivable. Cash and stock are "fragmented" in the same sense. Even stock transfers can yield capital expenditures.[130]

The *Smith*-line cases also mistakenly assert that an immediate ordinary deduction is necessary for the shareholder to recover his costs. Capital expenditure treatment requires that the basis in the transferred property be added to the basis of the shareholder's remaining shares.[131] The costs of an investment are therefore not lost: the increased basis offsets the amount realized on sale of the investment in calculating gain or loss. Learned Hand's comment that recovery of the shareholder's costs upon a nonprorata contribution is a question of "now or never"[132] shows that the court did not consider capitalization of the cost of the contributed property.

The ordinary-loss model also misdescribes the facts. "Loss" is an ambiguous word, but the *Smith*-line cases have created an odd definition of the word to allow ordinary deductions for what are better described as capital expenditures. The property transferred in a nonprorata contribution still has value and thus the taxpayer is not abandoning the property.[133] The transfer does not represent the expiration of his costs. While no investor likes costs, the transfer cannot be labeled involuntary.[134] The shareholder participates

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[130] *See* Fischer v. United States, 490 F.2d 218 (7th Cir. 1973); Hewett v. Commissioner, 47 T.C. 483 (1967); Ames v. Commissioner, 14 B.T.A. 1067 (1929), *aff'd*, 49 F.2d 853 (8th Cir. 1931). *See also* Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966) (function of term "ordinary" is to distinguish between capital expenditures and current expenses).

[131] For example, in Miller v. Commissioner, 45 B.T.A. 292 (1941), the portion of the basis not allowed as a loss on transfer "will of course be added to the cost basis of petitioner's remaining stock . . . [to] be recovered by petitioner when his remaining stock [is] sold or otherwise disposed of." *Id.* at 299. *See also* Estate of Foster v. Commissioner, 9 T.C. 930, 936 (1947).

[132] Scherman v. Helvering, 74 F.2d 742, 743 (2d Cir. 1935), quoted at *supra* text accompanying note 65.

[133] Ordinarily, a person does not abandon property having substantial value, and a transfer of valuable property, without consideration, would in the absence of explanation indicate a gift rather than an abandonment. Thus, in all the cases . . . in which a loss deduction was allowed on account of abandonment of property, it appears that such property had lost its useful or economic value, or that the taxpayer thought the property was without substantial value. Mack v. Commissioner, 45 B.T.A. 602, 607 (1941), *aff'd*, 129 F.2d 598 (2d Cir. 1942).

[134] In Hoile v. Commissioner, 4 T.C.M. (CCH) 247, 253-254 (1945), a taxpayer gave up realty to his employer to wipe out his employer's deficit so his employment could continue.

in the transfer too willingly for it to resemble a casualty loss or market decline. Nor is the loss like the totalling upon completion of an investment in which "loss" represents the excess of costs over income. Thus Judge Murdock was correct to dissent in *Wright* to the allowance of an immediate deduction:

> Whether [the shareholder] contributes cash or gives up part of his stock . . . his reason for so doing is to protect and make more valuable the stock which he continues to own. A relationship between the stock he gives up and that he continues to hold is thus established and he can have no loss on the one, when contributed, but must wait until he finally disposes of the other, for at that later time it may develop that he has a gain on the whole transaction.[135]

If a nonprorata contribution is a "loss" in any sense of the word, it is the kind of "loss" synonomous with the word "cost" and costs often must be capitalized.

Even if the transfer were some kind of "loss," section 263, denying an immediate deduction for capital expenditures, overrides the authorization of a loss deduction in section 165.[136] To allow an immediate ordinary deduction for a "cost" or "loss," the courts must first determine that the item is not a capital expenditure. A capital expenditure is one that originates in a capital transaction,[137] relates to a prior capital event,[138] or is attributable to future in-

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See id. at 253-54. The court found a gift, not loss, notwithstanding the business motives, saying that a voluntary contribution, without consideration, can in no way provide the basis for a loss. *See id.* at 254. *See also* Hitke v. Commissioner, 296 F.2d 639 (7th Cir. 1961) (transfer of stock was not involuntary conversion within § 1033, although taxpayer claimed only alternatives were seizure by majority shareholder or state receivership); Robins v. Commissioner, 15 B.T.A. 1068 (1929) (no legal compulsion although failure to sell would have meant loss of all investment); Tirrell v. Commissioner, 14 B.T.A. 1399 (1929) (no involuntary conversion although corporation's creditors threatened bankruptcy without the sale).

[135] 18 B.T.A. at 473. *See also* Deputy v. Du Pont, 22 F. Supp. 589 (D. Del. 1938), *rev'd,* 103 F.2d 257 (3d Cir. 1939), *rev'd,* 308 U.S. 488 (1940). The trial court judge wrote:

> [I] am also of the opinion that the word "losses" as used [in section 165(c)(2)] refers not to interim sums required to be paid out by the taxpayer in the course of the transaction, but refers to actual losses suffered by the taxpayer as a result of the transaction. Such losses cannot be computed until a transaction has been completed or reaches a stage where the loss can be calculated.

Id. at 600. *See also* Vaughn v. Commissioner, 15 B.T.A. 596, 622, *aff'd on reh'g,* 17 B.T.A. 620 (1929), quoted at *supra* text accompanying note 33.

[136] *See* I.R.C. § 161. *Cf.* Idaho Power Co. v. Commissioner, 418 U.S. 1, 4 (1974) (§ 263 overrides § 165 by virtue of § 161).

[137] *See* Woodward v. Commissioner, 397 U.S. 572, 577 (1970).

[138] *See* Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

come.[139] Section 165 does not avoid capitalization questions.[140]

In sum, a nonprorata contribution is a capital expenditure because the only plausible motive for the transfer is to preserve the shareholder's remaining investment in his corporation.[141] The *Smith* line seems now to be an odd forgotten island that allows a shareholder an ordinary loss for stock costs which are not lost, but which should be capitalized.

B. *Balanced Contributions*

While nonprorata contributions should be capitalized because they are investments for future returns, additional arguments support capitalization of "balanced" contributions. Balanced contributions are contributions where a shareholder can expect his remaining shares to recapture the value he has transferred because of arm's-length bargaining. For example, in the *Smith*-line cases of *Scherman, Burdick, Peabody Coal, Budd International* and *Wright,* new shareholders gave consideration of some kind to the corporation in return for the shares transferred to them.[142] The consideration should have prevented the old shareholders who provided the stock to be transferred from losing any value. Such balanced contributions should be capitalized because they resemble pro rata contributions and the issuance of new stock.

No loss is allowed for pro rata contributions of stock because the shareholders lose no economic value: the "remaining shares [absorb] the value inherent in the surrendered certificates."[143] The courts within the *Smith* line allowed loss deductions because they treated the contributions as nonprorata transfers.[144] But pro rata contributions can be distinguished from balanced contributions only by ignoring the consideration paid by new shareholders to the

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[139] *See supra* notes 43-44 and accompanying text.

[140] *See, e.g.,* Markwardt v. Commissioner, 64 T.C. 989, 995 (1975); Du Pont v. Commissioner, 37 B.T.A. 1198, 1275 (1938), *aff'd on other issues,* 118 F.2d 544 (3d Cir.), *cert. denied,* 314 U.S. 623 (1941).

[141] *See supra* text accompanying notes 39-44.

[142] *See Scherman,* 74 F.2d at 742; *Burdick,* 59 F.2d at 395; *Peabody Coal,* 8 F. Supp. at 845; *Budd Int'l,* 45 B.T.A. at 737, *Wright,* 18 B.T.A. at 471.

[143] Scoville v. Commissioner, 18 B.T.A. 261, 264 (1929). *See also* Kistler v. Burnet, 58 F.2d 687 (D.C. Cir. 1932); Taylor v. McLaughlin, 30 F. Supp. 19 (E.D. Pa. 1939); Murphy v. Commissioner, 4 T.C.M. (CCH) 813 (1945); Bed Rock Petroleum Co. v. Commissioner, 29 B.T.A. 118 (1933); Haft v. Commissioner, 20 B.T.A. 431 (1930).

[144] *See supra* note 50 and accompanying text.

corporation.[145]

Assume for illustration that a sole shareholder has a $100,000 basis in a corporation worth $100,000, that he transfers half of his shares to new shareholders and that the new shareholders pay $100,000 to the corporation. The old shareholder has parted with half of his interest in the initial corporate assets but has not lost any value and should have no deductible loss. He would have been willing to sell a half-interest in the old assets of the corporation for $50,000 paid directly to him, but he instead required that $100,000 be paid to the corporation; he has exchanged a half-interest in the original corporate assets for a half-interest in the $100,000 purchase price. Although the old shareholder disposed of a part of his interest in the corporation, the value of his remaining shares immediately reflects the new contribution and thus recaptures the value of the transferred shares. As long as the old and new shareholders are dealing at arm's length, the old shareholder can expect to lose nothing in the transaction.

In the *Smith* cases involving balanced contributions, there was not one old shareholder, but a group, and each existing shareholder contributed pro rata.[146] The transfers to new shareholders were undertaken not for cash, but to induce the recipients to extend loans to the corporation,[147] to perform services for the corporation,[148] or both.[149] Nevertheless, the effect of a balanced contribution is the same whether the corporation has one or several shareholders and whether the new shareholders pay cash or other consideration to the corporation. A balanced contribution involves no economic loss and should achieve no deductible loss.

Moreover, a balanced contribution of stock of the benefited corporation is economically equivalent to the corporation issuing stock. In the above hypothetical, for example, the parties could

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[145] Alternatively stated, the courts deem a contribution by a 100% shareholder to be nonprorata because they count the new shareholders without considering their balancing contribution. *See, e.g.*, Burdick v. Commissioner, 20 B.T.A. at 748.

[146] Scherman v. Helvering, 74 F.2d 742 (2d Cir. 1935), is nonprorata only because the other shareholder not before the court contributed more than his share.

[147] *See, e.g.*, Peabody Coal Co. v. United States, 8 F. Supp. 845 (Ct. Cl. 1934); Budd Int'l Corp. v. Commissioner, 45 B.T.A. 737 (1941), *rev'd*, 143 F.2d 784 (3d Cir. 1944), *cert. denied*, 323 U.S. 802 (1945); City Builders Fin. Co. v. Commissioner, 21 B.T.A. 800 (1930).

[148] *See, e.g.* Scherman v. Helvering, 74 F.2d 742 (2d Cir. 1935).

[149] *See, e.g.*, Burdick v. Commissioner, 59 F.2d 395 (3d Cir. 1932); Wright v. Commissioner, 18 B.T.A. 471 (1929), *rev'd on other grounds*, 47 F.2d 871 (7th Cir. 1931).

have reached the same end by having the corporation issue new shares equal in number to the shares held by the old shareholder before the transaction in exchange for the new shareholders' $100,000. In both cases, the old shareholder has disposed of half his interest in the initial assets of the corporation and received in return a half-interest in the $100,000 purchase price. Thus, in the *Smith*-line balanced contributions, the new employee or creditor might alternatively have been issued new stock. A shareholder is not entitled to a loss or other deduction when his corporation issues new stock even if the new issue price is considerably lower than his original purchase price. The old shareholder's basis in his stock interest remains constant and gain or loss is deferred until sale. Since a balanced contribution is functionally equivalent to a stock issuance, the shareholder should not recognize a loss pursuant to a balanced contribution. The shareholder's basis in the transferred shares should instead be allocated to the remaining shares.

C. *Encouraging Inferior Investments*

Allowing a current ordinary deduction for an expenditure which is in reality an investment encourages inferior investments. The most dramatic distortions in investment choice occur where the return from the investment is capital gain. Assume, for example, that a nonprorata contribution ultimately increases the value of the shareholder's stock and that the increase is treated as long-term capital gain. Assume also the shareholder has as an alternative to his contribution a new, nondeductible investment in stock. If the contribution were deductible, it would have two distinct advantages over the alternative. First, for the same economic burden, the investor could make a considerably larger contribution because the tax savings from the deduction would reduce the burden of the contribution. In a fifty percent tax bracket, a deductible contribution can be twice as large as a capitalized investment at the same after-tax cost.[150] Second, deductible contributions, mismatched

[150] Where B is the amount of the deductible investment and t is the tax rate applicable to ordinary income offset by the deduction, a transferor will save taxes of (tB). The investor thus has an after-tax cost for the deductible investment of $B - tB$ or $(1 - t)(B)$. Since b, the amount invested in the alternative capitalized investment, is not deductible, there is no tax savings and b is the after as well as before tax cost of the investment. If the after-tax

with capital gain treatment of the return, convert ordinary income into capital gain. In the fifty percent bracket, the conversion means that instead of effectively paying a fifty percent tax on the return from the investment, the taxpayer pays a twenty percent tax on his profit.[151]

Combining the two advantages for a fifty percent bracket taxpayer means that the investment in new stock must yield a seventy-five percent profit just to match a deductible contribution which breaks even.[152] Alternatively stated, if the new stock yields a reasonably healthy ten percent pre-tax profit, the deductible contribution can lose over thirty percent of the amount invested and still match the new investment.[153] Deduction of the contribution combined with capital gains treatment of the returns makes a

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cost of the two investments is the same, then $(1 - t)(B) = b$, or $B = [b \div (1 - t)]$. Where t, the tax rate, is equal to 50%, B is equal to $b \div (1 - .5)$, or $2b$. Hence for a taxpayer in the 50% bracket, for every dollar that can be invested in a capitalized investment, two dollars can be invested in the deductible alternative at the same after-tax cost. (The formulation ignores the lag between deductions and tax savings arising from them, but the adjustment to discount the tax savings of tB to its present value at the time of investment is minor).

[151] Sixty percent of capital gain is deducted so that only 40% of the gain is included as taxable income. *See* I.R.C. § 1202(a). In our assumed 50% bracket, the tax is 50% of 40% of the gain, or 20% of the gain.

[152] As noted at *supra* note 150, $b \div (1 - t)$ may be invested if the contribution is deductible, where b is the cost of a nondeductible investment. If that investment returns an economic profit of rate R, then the pre-tax return will be $[b \div (1 - t)] \times (1 + R)$. Since a shareholder gets no basis when costs are deducted, the full gross return will be subject to tax. The return will be capital gain, however, so that under § 1202(a) only 40% of it is taxed; hence the tax will be $(.4t) \times [b \div (1 - t)] \times (1 + R)$ and the after-tax return from the deductible investment will be $(1 - .4t) \times [b \div (1 - t)] \times [1 + R]$. If, on the other hand, the investment is not deductible, only b can be invested and at an economic return rate r, the pre-tax return will be $b(1 + r)$. Capitalization gives the shareholder a basis of b upon sale so that only profit r and not the full gross return will be subject to capital gains tax. Hence, the tax on the capitalized investment is $br(.4t)$ and the after-tax return is $b(1 + r) - br(.4t)$. Equating the after-tax returns of the two investments yields:

(1) $(1 - .4t) \times [b \div (1 - t)] \times [1 + R] = b(1 + r) - br(.4t)$;

(2) $(1 - .4t) \times [(1 + R) \div (1 - t)] = 1 + (1 - .4t)r$ [b factored out];

(3) $r = [1 + R \div (1 - t)] - [1 \div (1 - .4t)]$ [r isolated].

Where t is 50%, equation (3) becomes:

(4) $r = 2R + 75\%$. Even with no R (the return on the deductible investment), the capitalized investment must yield a 75% profit to compete with the deductible one. (For simplicity, these calculations assume that the basis of the contributed property is equal to its value and that the full basis is allowed as a loss. The assumption allows the formula to use the same figure for both the base of the profit rate and the deduction.)

[153] If $r = .10$ in equation (4), *supra* note 152, then $R = [(.10 - .75) \div 2]$ or $-.325$, or negative 32½%.

money-losing pre-tax investment preferable to a healthy pre-tax investment.

If the shareholder can receive only ordinary income such as dividends from both his contribution and the new stock alternative, then for a fifty percent bracket taxpayer the alternative investment need yield "only" twice the return of the deductible contribution.[154] Still, if the tax savings upon deduction allow more to be invested initially, the contribution will be made instead of the healthier alternative investment.

Allowing a deduction for the basis of contributed property also encourages the shareholder to make a nonprorata contribution of capital assets that have decreased in value merely to transmute a capital loss into an ordinary deduction. The shareholder will recognize only a capital loss upon the sale of a capital asset that has declined in value.[155] Capital loss offsets capital gain,[156] only forty percent of which is taxed.[157] Ordinary deductions, however, offset ordinary income, all of which would otherwise be taxed. If an ordinary deduction for the contribution of a capital asset were allowed, a fifty percent shareholder in a fifty percent tax bracket who has unrealized loss on the property would apparently prefer a nonprorata contribution to a sale of the property.[158] Absent tax effects, by contrast, a sale would yield the full remaining value of the property in cash or other sales proceeds, whereas a contribution would yield only half the value of the property since the share-

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[154] Equation (4), *supra* note 152, becomes $r = 2R$ if no capital gain is available.

[155] *See* I.R.C. § 1001(c). *See also id.* § 1221 (capital asset defined).

[156] *See id.* § 1222(9).

[157] *See id.* § 1202(a). If the taxpayer has only long-term capital loss, 50% (rather than 40%) may be deducted from ordinary income, *id.* § 1221(b)(1)(C)(ii), subject to a $3000 per year limitation. *See id.* § 1211(b)(2).

[158] Assume S is the percentage of shares of the corporation the shareholder owns after the contribution, V is the fair market value of the contributed property, t is the shareholder's tax rate (assumed constant) and B is the basis of the contributed property. A contribution of a capital asset accompanied by a deduction of basis ($SV + tB$) is more advantageous than an immediate sale $[V + .4t(B - V)]$ if $SV + tB > V + .4t(B - V)$. With S greater than or equal to 50%, and $t = 50\%$, the contribution will be more valuable after tax whenever V is less than B—where fair market value is less than basis.

If there will be prompt capital gain tax on the increase in share value ($.4tSV$), so the shareholder can keep only $(1 - .4t)(SV)$, then the comparison is $[(1 - .4t)(SV)] + tB > V + .4t(B - V)$. With $S = 50\%$ and $t = 50\%$, V must be 75% of B or less for the contribution to be advantageous. Even with immediate capital gain tax the nonprorata contribution becomes advantageous if 25% of the basis has been lost.

holder owns only half of the benefited corporation. Capitalization of the cost of the contribution eliminates this tax-induced bias toward contribution.[159]

III. Critique of the Constructive-Sale Model

A. *The Fiction of Taxable Receipt*

The *Downer*-line cases say that a nonprorata contribution is a taxable sale because of something the contributing shareholder receives in return for the transfer. The *Smith*-line cases, when thoughtful, usually justify their result by rejecting the idea that taxable consideration was received. On that narrow issue, the *Smith* cases seem to have the better argument. But reading the *Downer* cases so literally is a mistake. They are better explained as creating a legal fiction to defeat the ordinary-loss model. The *Ames* model, however, yields the correct result more simply and without need for legal fiction. Arguably, the legal fiction in the constructive-sale model has misdirected the courts' focus to the taxability of what was received and is thus responsible for the waivering and inconsistency in the decisions. If the only rationale for the *Downer* model is to defeat the *Smith* model, then the *Ames* model does it better.

The *Downer* cases have stated that a constructive sale arises from what the contributing shareholder receives. The Seventh Circuit in *Wright* originated the constructive-sale model by noting the "contemplated advantage" the transferor received.[160] After *Wright*, the ordinary-loss model cases rejected the position that the transferor received anything taxable.[161] Subsequently, *Downer* returned

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[159] *See* United States v. Keeler, 308 F.2d 424 (9th Cir. 1962) (denying loss where shareholder had promised other investors in his corporation to make good their loss when they sold their stock and debentures), *cert. denied*, 373 U.S. 932 (1963). The *Keeler* court stated:

> Had taxpayer chosen to make his investment by direct purchase of stock, the resultant loss would be a capital loss under [section] 165(f); had he made his investment in the form of a direct loan to the corporation . . . the loss would have been a nonbusiness bad debt deductible as a capital loss under [section] 166(d). To hold that he is entitled to more favorable treatment because he chose to make his investment in the manner he did, would be entirely unrealistic, and would create a tax loophole that was never intended by Congress.

Id. at 434. *See also* Boone v. Commissioner, 33 T.C.M. (CCH) 663, 668 (1974) (surrender of debentures to corporation for tax considerations to obtain ordinary rather than capital loss).

[160] *See* 47 F.2d 871, 872 (7th Cir. 1931), quoted at *supra* text accompanying note 102.

[161] *See supra* notes 59-71 and accompanying text.

to the constructive-sale theory, emphasizing that the taxpayer hoped to receive specific benefits.[162] *Smith* itself then distinguished *Downer* because in *Smith* the shareholders received no consideration, whereas the taxpayer in *Downer* purportedly did.[163] A later case in turn distinguished *Smith* because the consideration was purportedly more distinct and capable of measurement than that received by the shareholders in *Smith*.[164]

Looking to what the transferor receives pushes the constructive-sale model toward absurdity.[165] The transferring shareholders anticipate increases in the value of retained shares and in future dividends, but neither item is currently realized under normal tax principles:

> [I]t is difficult to conclude that a nonstockholder, who makes a contribution of land to a manufacturing corporation in the hope that the use of the land as a plant site will in the long run benefit the contributor's business, or reduce his school taxes, or employ his son, has received anything by way of money or property. In such a case, it should be held that no money or property has been received and therefore no amount has been realized on the disposition of the property.
>
> The same consideration should govern the treatment of the shareholder who makes a disproportionate contribution of appreciated property to the corporation. If he receives nothing in return he has realized no gain. True, his shares of the corporation may have increased in value by reason of the contribution but it would go beyond usual concepts to treat a change in the value of the shares of stock as a receipt of property.[166]

The theory that the transferring shareholder has received something taxable simply cannot be applied consistently. Where, as in *Downer* for example, one shareholder transfers stock to pay for services to the corporation, the other shareholders who do not par-

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[162] *See* 48 T.C. at 92-93, quoted at *supra* text accompanying note 112.

[163] *See* 66 T.C. at 649, quoted at *supra* text accompanying note 117.

[164] *See supra* note 120.

[165] If the issue is truly the taxability of the consideration received, then the ordinary-loss cases have the better approach. *See Scherman*, 74 F.2d 742 (2d Cir. 1935), quoted at *supra* text accompanying note 65; *Burdick*, 59 F.2d 395 (3d Cir. 1932), quoted at *supra* text accompanying note 62; *Peabody Coal*, 8 F. Supp. 845 (Ct. Cl. 1934), quoted at *supra* text accompanying note 60; *Budd Int'l*, 45 B.T.A. 737 (1941), *rev'd*, 143 F.2d 784 (3d Cir. 1944), *cert. denied*, 323 U.S. 802 (1945), quoted at *supra* text accompanying note 70.

[166] Landis, *supra* note 8, at 260.

ticipate in the contribution should theoretically be taxed on their pro rata share of the benefit of the services, but of course they are not. Similarly, if the employee who performs the services receives shares of the benefited corporation, he should be charged, when he receives the shares, with the value that his future services will add to their worth.[167] If the issue really is what the shareholder has received, a shareholder transfer directly to the corporation should yield the greater tax since the increase in value does not depend on a third party actually delivering a contemplated advantage to the corporation. Yet based upon *Downer,* a transfer to the corporation involves no realization whereas the transfer to the outsider does. Constructive sale rests on a legal fiction of taxable receipt which is implausible when taken literally.

Disagreement with *Wright* over the taxability of the consideration received led many courts to reject its result. After *Downer,* uncertainty concerning what actually was received apparently invited the court in *Smith* to exempt its transfer from the scope of *Downer.*[168] The *Downer* shareholder received only the expectation that the officer's services would benefit the shareholder's stock and the *Smith* shareholders received nothing less. But instead of explicitly overruling *Downer,* the *Smith* court rejected the logic of *Downer* by employing a fragile distinction. If the history of the *Wright* appeal is a reliable indicator,[169] the future may hold yet another cycle in which dissatisfaction with the constructive-sale model feeds the error of ordinary loss.

Arguably, however, the error is in the attempt to take the constructive-sale model literally. The model is a legal fiction used to accomplish a result that the fiction does not explain. The reasons for the results must be distilled from the results in context and not from the legal fiction.

One plausible explanation of the *Downer* model is that the courts are using it, not to tax the intangible consideration the transferor receives, but rather to preclude allowing an ordinary loss equal to the transferor's basis. It has been argued here that the *Ames* or capitalization model is correct. The transferor's costs, properly viewed, are capital and should not be deductible as either

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[167] *See* Manwell, *supra* note 8, at 279.
[168] *See* 66 T.C. at 649, quoted at *supra* text accompanying note 117.
[169] *See supra* text accompanying notes 59-71.

a current or ordinary loss. Where the value of the property transferred is less than or equal to its basis in the transferor's hands, the *Downer* model pushes away from *Smith* and toward *Ames*: it changes the loss from ordinary to capital by creating a sale or exchange and reduces or erases the amount of the loss.

A good example of a court using constructive sale as a legal fiction to defeat a *Smith*-model loss is *Clement v. Commissioner.*[170] As in many cases, the shareholders in *Clement* attempted to rescue the corporation from bankruptcy by transferring stock to creditors.[171] The Board of Tax Appeals, speaking through Judge Murdock, relied on the Seventh Circuit's then-recent decision in *Wright* to find a constructive sale.[172] The court, however, then denied the shareholders any loss because the shareholders did not prove to the court's satisfaction the value of the transferred stock.[173] The court had computed the book value of the transferred stock for other reasons in the decision[174] and therefore some value, however approximate, could have been ascertained on the evidence. But Judge Murdock, the author of the *Clement* opinion, had dissented five years earlier in the court's decision in *Wright,* arguing that the shareholders should not recognize their costs until they sell their remaining stock.[175] By denying a loss in *Clement* the court was plausibly moving toward the capitalization model, using the constructive-sale theory only because Murdock's preferred path was blocked by the court's majority opinion in *Wright.*

Sack v. Commissioner[176] similarly is best explained as the court's rejection of the *Smith* line. The shareholder in *Sack* transferred shares he had purchased the day before to the new management of his corporation.[177] Allowing an ordinary deduction for Sack's costs would have been intolerable given that similar payments in cash cannot be deducted.[178] As in *Clement,* the court found that the

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[170] 30 B.T.A 757 (1934).

[171] *See id.* at 759. In form, the transfer was a sale of the stock for $1 per share, but the stock was clearly more valuable than that. *See id.* at 762-63.

[172] *See id.* at 762.

[173] *See id.* at 763.

[174] *See id.*

[175] 18 B.T.A. at 474, quoted at *supra* text accompanying note 135.

[176] 33 T.C. 805 (1960).

[177] *See id.* at 807-08.

[178] *See, e.g.,* Deputy v. Du Pont, 308 U.S. 488 (1940); Du Pont v. Commissioner, 37 B.T.A. 1198, 1275 (1938) (business expense denied for payments to executives), *aff'd on other*

taxpayer realized a constructive sale but no loss because he had not proved any decline in the value of his transferred shares.[179]

Downer v. Commissioner[180] is also explainable as a reaction to the error of allowing ordinary losses. The *Downer* court cited Judge Murdock's dissent in *Wright* as appealing, but rejected that position because the court was "not disposed to chart a new course."[181] The court was apparently impressed by the *Smith* cases which held that a nonprorata contribution of property is an event upon which some kind of loss can be recognized.[182] *Downer* also cited cases holding that cash transfers must be capitalized and distinguished those cases from property transfers.[183] The court cited one property transfer case but distinguished it as involving the question of expenses and not losses.[184] The *Downer* court was thus trapped in a morass of conflicting cases. It is submitted, however, that *Downer* considerably overestimated the force of the *Smith* cases and underestimated the legal force of the case for capitalization under *Ames*. In any event, *Downer,* in holding that the shareholder had a capital loss, drew back from the *Smith*-model error of allowing the shareholder an ordinary deduction.[185]

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grounds, 118 F.2d 544 (3d Cir. 1941). *Cf.* cases cited at *supra* notes 39-42.

[179] *See* 33 T.C. at 808.

[180] 48 T.C. 86 (1967).

[181] *Id.* at 92.

[182] *See id.* at 91 ("[T]he authorities consistently support the proposition that, aside from the question of nature and extent of the loss, the type of transaction such as is involved herein can give rise to a deductible loss.").

[183] *See id.* at 90-91, quoted at *supra* text accompanying note 75, criticized at *supra* text accompanying notes 129-30. *But see* authorities cited *supra* note 10.

[184] 48 T.C. at 92 n.7 (citing Hewett v. Commissioner, 47 T.C. 483 (1967)). *See supra* text accompanying notes 133-41.

[185] The use and awkwardness of constructive sales to deny an ordinary deduction is also illustrated by Fred H. Lenway & Co. v. Commissioner, 69 T.C. 620 (1978), *aff'd per curiam,* 620 F.2d 310 (9th Cir. 1980). In *Lenway,* an outside investor acquired an interest in one Gulf corporation by buying newly issued shares from Gulf. *See id.* at 622-23. The old shareholders, including the taxpayer corporation, warranted Gulf's net worth which later turned out to be disastrously low. *See id.* at 624-25. The contract, however, had allowed Lenway to satisfy its warranty by surrendering shares of Gulf, and Lenway surrendered all of its shares. *See id.* at 625. Lenway seemingly could have kept an interest in Gulf worth over twice the cash it needed to contribute under the warranty, but the opinion indicates no allegation of bad faith nor further explanation of the economics behind the surrender.

Lenway claimed an ordinary "abandonment" loss under § 165, but the court, relying on the *Arrowsmith* doctrine, *see, e.g.,* United States v. Keeler, 308 F.2d 424, 432-34 (9th Cir. 1962), *cert. denied,* 373 U.S. 932 (1963); Schenk, *Arrowsmith and Its Progeny: Tax Characterization by Reference to Past Events,* 33 Rutgers L. Rev. 317 (1981), said the loss was

In contexts outside shareholder contributions, the constructive sale is similarly used as a legal fiction to achieve a purpose other than taxation of intangible returns. In *United States v. Davis*,[186] for example, the Supreme Court held that a husband realized capital gain upon the transfer of appreciated property to his wife in a divorce settlement.[187] The Court stated that there was a taxable receipt in "the release of the wife's inchoate marital rights,"[188] but it is difficult to take that seriously. Divorce may be a joy to both parties, but release from the claims of marriage seems too intangible a benefit to tax. Would a husband have income if his wife just left him? The decision is better seen as taxing stock appreciation, a more commercial value than "inchoate marital rights," and as taxing it at the last chance to tax the party in whose hands the appreciation occurred.[189] That rationale, however, is inapplicable to a shareholder contribution.[190]

capital because the arrangement was from "start to finish . . . the embodiment of a capital transaction." 69 T.C. at 628. That rationale is satisfactory and sufficient, but the court also said that the taxpayer had presumptively received fair value for its warranty within the rationale of *Downer*, and that the benefits inuring for its warranty were more distinct and capable of measurement than those in *Smith*. *See id.* at 628.

The *Downer* model is literally incompatible with the result the court reached. The constructive-sale model should have required Lenway to treat the fair market value of the surrendered stock as an amount realized, whereas the court in fact allowed a loss of all Lenway's basis without any reduction for amount realized. *See id.* at 632-33 (dissenting opinion). The dissent would have allowed an ordinary deduction because Lenway did not anticipate disposing of its Gulf shares when it made the warranty, *see id.* at 630, but it seems odd to say that a grantor of a warranty did not anticipate satisfying it. Warranty payments seem the paradigm of payments under *Arrowsmith* that relate back to the transactions from which they arose. The dissent strained to find an ordinary deduction. *See id.* at 633-38. The majority used *Downer* to deny a properly-denied ordinary deduction, but the constructive sale confused the issue.

[186] 370 U.S. 65 (1962).

[187] *See id.* at 71.

[188] *Id* at 72.

[189] If Mr. Davis had paid the property settlement in cash, the cash would presumably have been post-tax money. *See* I.R.C. § 71(c). The decision ensures that marital settlements in property are also made from and received as post-tax money. The Court found that the stock was Mr. Davis' property when the appreciation arose and that he could be charged with knowledge of the tax due. *See* 370 U.S. at 68-71. For Mrs. Davis the tax would have been a trap, but using the constructive-sale doctrine the court taxed Mr. Davis. *See id.*

[190] If *Davis* is best explained as allocating the tax on appreciation to Mr. Davis at the last opportunity, then it is distinguishable from a nonprorata contribution because there is a later opportunity to tax the shareholder. A contribution, if successful, will give the shareholder cash returns which will be taxed. Not all contributions will prove successful, but that is hardly a justification for greater tax. It seems wise to wait and see how the contribution

Similarly, the constructive-sale cases on compensation with appreciated property[191] sometimes purport to tax receipts,[192] but that is absurd. If an employer received a taxable receipt whenever he paid employees who work for him, then no employer would be allowed to deduct compensation. The deduction would be negated by an offsetting income item from the employees' services. Although the legal fiction hides the rationale, the employee compensation cases seem forced by the need for fair accounting once a deduction is allowed for the fair market value of the property transferred.[193] Without the constructive sale, the deduction of unrealized appreciation would be a sheltering deduction, leaving the employer with untaxed cash in-hand.[194] Again, that rationale is inapplicable to shareholder contributions.[195]

In any event, the courts in the *Downer* line appear to be reaching toward an *Ames* or capitalization result. If that is the motive, the courts should adopt *Ames* expressly rather than adopting the confusing legal fiction of the constructive-sale doctrine.

B. *Constructive Sales Re-examined*

Although the argument that a shareholder has received something taxable is not particularly persuasive, taxing gain upon a

fares in more tangible terms. *See supra* text accompanying note 135.

[191] *See* cases cited at *supra* note 98.

[192] In International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943), for instance, the Second Circuit said that an employer had gain upon the compensatory transfer of appreciated shares to employees: "[S]ince the bonuses would be invalid to the extent that what was delivered to the employees exceeded what the [employees' services] were worth, it follows that the consideration received by the [employer] from the employees must be deemed to be equal at least to the value of the shares. . . ." *Id.* at 313.

[193] The compensation deduction is measured by the fair market value of the property. *See, e.g., id.* at 312; Smith v. Russell, 76 F.2d 91 (8th Cir.), *cert. denied,* 296 U.S. 614 (1935).

[194] Assume, for instance, that a corporation receives $100*x* from operations in a year and uses $10*x* to buy some investment stock. The stock goes up to $100*x* by the end of the year and the corporation uses it to pay employees. The corporation gets a $100*x* deduction and absent the constructive-sale doctrine would report no profit. In fact, however, the corporation has $90*x* of the $100*x* it made during the year; it made $100*x* from operations and it devoted $10*x* of that cash to compensation. The constructive-sale doctrine would treat the employer as receiving $100*x* sales proceeds from the sale of the stock and thus would tax the $90*x* the employer actually received.

[195] Under the rationale of *supra* note 194, there is no need for the constructive-sale doctrine for nonprorata shareholder contributions. Even if a loss were allowed under the *Smith* model, § 165(b) limits the loss to the shareholder's adjusted basis in the contributed property so there is no sheltering deduction. *See* I.R.C. § 165(b).

nonprorata contribution has some theoretical merit. Because a nonprorata contribution is an investment, it should, given the income tax, consist of previously taxed assets. If cash equal to the fair market value of the property were contributed, for example, the cash by presumption would have previously borne tax. Nonprorata property contributions have an unfair advantage over cash and other competing investments if the courts allow the contribution investment to be made with unrealized appreciation.

Treating a nonprorata contribution as a constructive sale is also consistent with the theory that a nonprorata contribution is a capital expenditure. Unless some statutory nonrecognition provision applies,[196] a taxpayer realizes gain or loss when he exchanges appreciated or depreciated property in making a capital expenditure.[197] A rule requiring recognition of gain or loss is consistent with the capitalization of cash expenditures[198] since cash always has a basis equal to its face amount and will not produce gain or loss even in a taxable transaction. Equating the tax treatment of investments is thus a worthy theoretical goal supporting the *Downer* result.[199]

Nonetheless, a rule treating nonprorata contributions as constructive sales would be inconsistent with cases where nonrecognition of gain or loss is clear. For example, a constructive sale for "balanced" contributions would require a legal distinction between economically equivalent transactions, that is, between "balanced" contributions and the issuance of new shares.[200] Moreover, even for nonprorata contributions that are not balanced, a constructive sale would create an inconsistency with the rule for pro rata contributions. A sole shareholder or shareholder joining in a pro rata con-

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[196] *See, e.g.*, I.R.C. § 1031.

[197] If a contribution involves gain or loss, the basis added to the shareholder's remaining shares would require adjustment. *See, e.g.*, Vaughan v. Commissioner, 17 B.T.A. 620 (1929) (basis not recovered as loss is added to the retained shares). *Cf.* I.R.C. § 358(a)(1)(A)(iii), (B)(ii) (increasing or decreasing a shareholder's basis in shares to reflect gain or loss recognized in a generally nonrecognition transaction).

Manwell, *supra* note 8, 1 J. Corp. Tax'n at 278 (1975) presents the argument that basis must be deducted upon a nonprorata contribution to recover the shareholder's costs and that *Downer* was therefore wrongly decided. The argument simply ignores basis adjustments to retained shares as an adequate remedy.

[198] *See supra* notes 39, 129-30, 178 and accompanying text.

[199] *See, e.g., supra* notes 150-59 and accompanying text.

[200] *See supra* notes 142-49 and accompanying text.

tribution need not recognize gain because the contribution is not a meaningful change in position.[201] In a pro rata contribution, the shareholder will recapture the full value of the contributed property immediately through an increase in the value of the retained shares. A shareholder making a nonprorata contribution, by contrast, expects to recover his investment eventually, but he cannot immediately recapture the full value of what he has transferred. Since the nonprorata contribution is economically less advantageous, its tax treatment should not be less advantageous than the treatment of pro rata contributions.

Finally, a contributing shareholder seems to be worse off than he would be with simple unrealized appreciation. The contributing shareholder has disposed of his appreciation at least temporarily. Failure to tax unrealized appreciation undoubtedly affects investor behavior, but given that unrealized appreciation is not taxed, it seems inconsistent to tax the appreciation in contributed property.

Administrative considerations also weigh against constructive sales. Constructive sales require the taxpayer, the government and the courts to undertake the often burdensome job of valuing the contributed property. Where there is no bargaining to define value, the law must rely on difficult and inaccurate appraisals. Sometimes the contributed property might be easy to value, but it would be unfortunate to make a distinction in treatment based upon administrative concerns. If two taxpayers are similarly situated and contribute property with equal real gain, small differences in the ascertainability of value should not result in one recognizing the gain and the other not. Delaying taxation until the transaction is closed seems the wiser approach.[202]

Most of the cases have involved contributions of property that would yield a loss on sale.[203] Where the contributed property has declined in value, a taxpayer can recognize the loss, if he desires,[204] simply by selling the property and contributing the cash sale pro-

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[201] *See* cases cited at *supra* note 50.

[202] *See supra* text accompanying note 135.

[203] Only in Scherman v. Helvering, 74 F.2d 742 (2d Cir. 1935), and Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979), does it appear that gain would be recognized had the contributed property been treated as sold.

[204] Since both the shareholder and the corporation derive their basis from the shareholder's basis in his contributed property, *see* I.R.C. §§ 362(a), 358(a)(1), a shareholder might prefer nonrecognition to obtain a double loss.

ceeds. Leaving the shareholder to his private remedy of actually selling the property seems justified by the burden of appraisals on the courts and Internal Revenue Service and by the inaccuracy of appraisal results.[205] In sum, given nonrecognition for like transactions and the administrative burdens of a constructive sale, the *Ames* model seems preferable to *Downer*.

IV. Alternative Explanations for Capitalization

A court could reach the *Ames* or capitalization result by concluding (1) that a shareholder does not "ordinarily" make nonprorata contributions within the meaning of the term "ordinary and necessary" in sections 162 and 212 of the Code, (2) that the contribution is not "proximately related" to the shareholder's own business or profit, or (3) that the transfer is a "contribution to the capital" of the corporation. The cases using alternative rationales add to the weight of legal authority for *Ames*, but the alternatives ultimately are not as satisfying as the explanation that a nonprorata contribution is a capital investment.[206]

A. *Ordinariness*

Expenses, whether for a trade or business or for the production of income, are deductible only if ordinary and necessary.[207] One rationale commonly given to deny a deduction for shareholder expenses is that a shareholder does not "ordinarily" bear what is properly a burden of his corporation.[208] The lower court decisions are inconsistent, however. They have allowed a shareholder an ordinary deduction even where the expense benefits the shareholder only by benefiting his corporation[209] and where the shareholder

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[205] Professor Cooper argues that the courts have been unduly conservative in valuing property in the taxpayers' favor. *See* G. Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance 44-55, 84-89 (1979). If the cases turn out to involve a loss in fact or under court findings, then a constructive sale created to reach unrealized appreciation will not serve its function.

[206] *See supra* text accompanying notes 24-44.

[207] *See* I.R.C. §§ 162(a), 212.

[208] *See, e.g.*, Deputy v. Du Pont, 308 U.S. 488, 494-97 (1940); Rittenburg v. United States, 267 F.2d 605, 607 (5th Cir. 1959), *cert. denied*, 361 U.S. 931 (1960); Missouri-Kansas Pipe Line Co. v. Commissioner, 148 F.2d 460, 461 (3d Cir. 1945); Hewett v. Commissioner, 47 T.C. 483 (1967). *Cf.* Kaplan v. Commissioner, 21 T.C. 134, 146 (1953) (shareholder entertainment expenses).

[209] *See* Beerman v. United States, 390 F.2d 638 (6th Cir. 1968) (shareholder's attorney

will get a return for his expenses only through enhancing the value of his stock investment.[210]

The inconsistencies may be rooted in a Supreme Court standard that was not particularly helpful in explaining the function of the word "ordinary": "One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."[211] Apparently the Court thought at one time that what was common and accepted in the community would define "ordinary."[212] The legislative history, however, does not seem to require conformity to accepted or common ways of doing business and, in fact, the term seems to lack any special function whatsoever.[213]

The Supreme Court has now stated that the principal function of the term "ordinary" is to distinguish current expenses from capital expenditures.[214] Perhaps this will improve the consistency of the decisions, although a skeptic might argue that the word "ordinary" says no more about capitalization than it does about conformity. Certainly a deduction is not allowed simply because an expenditure is "ordinary" if it is also a capital expenditure.[215] The courts should focus on the functions and scope of capitalization, and not upon the meaning of the word "ordinary," in deciding the proper treatment of shareholder contributions.

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fees relating to his guarantee of corporation's note were deductible).

[210] *See* Graham v. Commissioner, 326 F.2d 878 (4th Cir. 1964) (shareholder proxy fight expenses deductible); Surasky v. United States, 325 F.2d 191 (5th Cir. 1963) (same).

[211] Welch v. Helvering, 290 U.S. 111, 115 (1933).

[212] *See id.* at 114.

[213] The term "ordinary expenses" appeared in the original enactment of the corporate income tax, Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 11, 113, although the term was not applied to individual expenses until the Revenue Act of 1918, ch. 18, § 214(a), 40 Stat. 1057, 1066. *See* Griswold, *An Argument Against the Doctrine that Deductions Be Narrowly Construed as a Matter of Legislative Grace,* 56 Harv. L. Rev. 1144, 1145 (1943).

In the legislative history of the predecessor to § 212 of the Code, Congress adopted the judicial gloss on "ordinary" that expenses must bear a proximate relation to the production of income. H.R. Rep. No. 2333, 77th Cong., 2d Sess. 75 (1942).

[214] Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966). The position was anticipated in Wolfman, *Professors and the "Ordinary and Necessary" Business Expense,* 112 U. Pa. L. Rev. 1089, 1111-12 (1964).

[215] Section 263 has priority over § 212 by reason of § 161. *See* Commissioner v. Idaho Power Co., 418 U.S. 1, 17-18 (1974).

B. *Proximate Relationship to Shareholder's Profit*

Additional support for capitalizing nonprorata contributions is found in the doctrine that a shareholder's payment of expenses attributable to the corporation's business is neither proximately related to the shareholder's own business nor undertaken for the production of the shareholder's own profit. A taxpayer cannot use the business or profit of another to meet the requirement that the expenses be incurred in the taxpayer's business or be for the production of profit.[216]

The doctrine, while accepted, is troublesome. There is no logical reason why an expense cannot be for both the shareholder's and the corporation's profit. Since the shareholder makes the transfer to receive greater dividends or gain from his shares, he has a profit of his own. Arguably, the corporation is a third party whose benefit is irrelevant in determining the treatment of the shareholders.[217] While the "not in the shareholder's business" doctrine thus may be flawed, it nevertheless reinforces capitalization of shareholder expenses that are primarily related to the corporation's operations.[218]

C. *Contribution to Capital*

Labelling the transaction a contribution to the capital of the corporation mandates capitalization. The regulations list as examples of capital expenditures: "Amounts assessed and paid under an

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[216] *See, e.g.,* Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593-94 (1943) (corporate shareholder paid operating deficit of wholly owned corporation); Deputy v. Du Pont, 308 U.S. 488, 493-94 (1940) (shareholder expenses in connection with sale of corporate stock to corporate employees); Fischer v. United States, 490 F.2d 218, 220-22 (7th Cir. 1973); United States v. Keeler, 308 F.2d 424, 433 (9th Cir. 1962); Rittenberg v. United States, 267 F.2d 605, 607 (5th Cir. 1959); Hudlow v. Commissioner, 30 T.C.M. (CCH) 894, 900 (1971); Hewett v. Commissioner, 47 T.C. 483, 488 (1967); Rand v. Commissioner, 35 T.C. 956, 960 (1961); Ihrig v. Commissioner, 26 T.C. 73, 76 (1956); Balsam Trust v. Commissioner, 3 T.C.M. (CCH) 1204, 1206 (1944); Du Pont v. Commissioner, 37 B.T.A. 1198, 1274 (1938), *aff'd on another issue,* 118 F.2d 544 (3d Cir. 1941), *cert. denied,* 314 U.S. 623 (1941); Ames v. Commissioner, 14 B.T.A. at 1071 (1929).

[217] The courts may not always intend to imply capitalization when they talk about the relationship of the expense to the corporate business. Possibly they mean that such expenses never affect the shareholder's tax, even through an increase in basis. *See, e.g.,* Kahn v. Commissioner, 26 T.C. 273, 275 (1956); Roach v. Commissioner, 20 B.T.A. 919, 925-26 (1930) (entertainment expenses).

[218] *See* cases cited at *supra* note 39. *Cf.* Fischer v. United States, 490 F.2d 218, 221-23, 222 n.6 (7th Cir. 1973) (disallowing current deduction where expenses were related to the corporation's financing operation and not to the taxpayer's personal stock dealings).

agreement between . . . shareholders . . . or voluntary contributions to the capital of the corporation for any corporate purpose. Such amounts are capital investments and are not deductible."[219] The courts sometimes hold that a shareholder cannot deduct his payments of corporate expenses because he has made a contribution to capital.[220]

Several courts applying the *Smith* model have drawn a distinction between pro rata surrenders of stock of the corporation, which properly bear the label "contribution to capital," and nonprorata surrenders which purportedly do not.[221] Nothing in the label "contribution to the capital of the corporation" supports that distinction. For example, when a shareholder surrenders debentures or forgives other corporate indebtedness, the surrender is considered a contribution to capital even though nonprorata. The shareholder receives no loss or other deduction.[222] If the claim surrendered to the corporation is an equity rather than a debt interest, the result should be the same. Nonprorata payments by shareholders of corporate expenses, moreover, have been held to be nondeductible.[223]

Other cases within the *Smith* line have distinguished transfers of stock of the corporation from transfers of other property on the ground that the corporation received no asset from the shareholder. In *City Builders Finance Company v. Commissioner,*[224] the shareholders transferred half of their stock to a prospective lender as inducement for a loan to the corporation.[225] Because the prop-

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[219] Treas. Reg. § 1.263(a)-2(f). *See also id.* § 1.118-1 (assessments or other amounts credited to corporate surplus constitute an additional price paid for stock).

[220] *See, e.g.,* Kout v. Commissioner, 31 T.C.M. (CCH) 1044, 1052 (1972); Rink v. Commissioner, 51 T.C. 746, 751 (1969).

[221] *See* Smith v. Commissioner, 66 T.C. 622, 647 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979); Duell v. Commissioner, 19 T.C.M. (CCH) 1381, 1384 (1960); Miller v. Commissioner, 45 B.T.A. 292, 299 (1941); Wright v. Commissioner, 18 B.T.A. 471, 472-73 (1929), *modified,* 47 F.2d 871 (7th Cir. 1931).

[222] *See* Perlman v. Commissioner, 252 F.2d 890 (2d Cir. 1958) (20% shareholder had no loss upon forgiving taxed but unpaid salary owed to him); Lidgerwood Mfg. Co. v. Commissioner, 229 F.2d 241 (2d Cir. 1956) (denying shareholder deduction for bad debts acquired in exchange for corporate stock), *cert. denied,* 351 U.S. 951 (1956); Boone v. Commissioner, 33 T.C.M. (CCH) 663 (1974) (denying 18% shareholder loss on surrender of debentures).

[223] *See, e.g.,* Deputy v. Du Pont, 308 U.S. 488 (1940) (16% shareholder); Rand v. Commissioner, 35 T.C. 956 (1961) (33% shareholder); Ihrig v. Commissioner, 26 T.C. 73 (1956) (50% shareholder).

[224] 21 B.T.A. 800 (1930).

[225] *See id.* at 802.

erty surrendered was stock of the benefited corporation, the court found that there was "no additional capital (invested or otherwise) in the corporation, and no enrichment of . . . the corporation."[226] The court therefore allowed a deductible loss.[227]

The courts have also refused to find a contribution to capital where the transfer is to a third party rather than directly to the corporation. In *Kress v. Stanton,*[228] the shareholder sold stock to an employee of the corporation at a bargain price.[229] The Service argued that the bargain was a contribution to the capital of the corporation.[230] The court answered that "the corporation, as such, did not enter into this transaction," and allowed the shareholder to deduct the bargain amount.[231]

The Senate Finance Committee rejected the distinction between transfers to the corporation and transfers to a third party for the benefit of the corporation in a 1969 report.[232] In explaining the adoption of section 83, which involves transfers of property for services, the Committee stated:

> In general, where a parent company's or shareholder's stock is used to compensate employees . . . , the transfer of stock by the parent company or shareholder is to be treated as a capital contribution to the company which is to be entitled to a deduction in accordance with the [section 83] rules. The parent company or the shareholder merely is to reflect the contribution as an increase of the equity in the company which is entitled to the compensation deduction.[233]

In mandating contribution to capital treatment where a shareholder transfers shares to a third party, the committee report re-

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[226] *Id.* at 803. *But see* Boone v. Commissioner, 33 T.C.M. (CCH) 663 (1974) (surrender of debentures constitutes a contribution to capital although transaction did not increase working capital). The court in *Schleppy* stated:

> The government on appeal avoids the use of the term contribution to capital since, of course, the surrender of a corporation's capital stock without consideration does not add to the corporation's capital or assets. However, the term is used in a number of cases as a shorthand method of describing such surrender.

Schleppy v. Commissioner, 601 F.2d 196, 197 n.2 (5th Cir. 1979).

[227] 21 B.T.A. at 803.

[228] 98 F. Supp. 470 (W.D. Pa. 1951), *aff'd per curiam,* 196 F.2d 499 (3d Cir. 1952).

[229] *See id.* at 473.

[230] *See id.* at 474.

[231] *Id.* at 476.

[232] *See* 1969 Finance Comm. Report, *supra* note 10, at 123-24, *reprinted in* 1969 U.S. Code Cong. & Ad. News at 2155.

[233] *Id.*

jected the rationale employed in *City Builders Finance Company*. The Treasury regulations under section 83 adopt the Committee's construction that transfers to employees are capital contributions.[234] Although the committee report and the regulations focus only upon transfers for compensation, the same treatment should apply where the transfer serves some other corporate purpose.[235]

While the contribution-to-capital label thus generally supports capitalization of shareholder nonprorata transfers, labelling the transfer a contribution to capital may promote uncertainty. Although the regulations mandate capitalization of a contribution to capital,[236] courts have considered the label compatible with the *Smith*[237] and *Downer*[238] models as well. Moreover, the label invites courts to focus upon the corporation instead of the shareholder.[239] That the corporation has received a contribution may be implausible where it is not a party to the transaction or where it receives only its own stock. Still, the character of the receipt at the corporate level should not affect the shareholder. If the shareholder makes a capital expenditure, the treatment of the corporation should not change that result.

V. Conclusion

For over fifty years, there have been three inconsistent explanations of what a nonprorata shareholder contribution is and three different ways to tax it. The *Smith* model holds that the contribution is like a loss but ignores the fact that the shareholder is making an investment or preserving his past investment. The *Downer* model likens the contribution to a sale of the contributed property

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[234] *See* Treas. Reg. § 1.83-6(d). The regulation does not specify the consequences of a capital contribution, but under Treas. Reg. § 1.263(a)-2(f), the result, nondeductibility, is clear.

[235] The committee reports seem persuasive notwithstanding that a "mistaken opinion of the legislature concerning the law, does not make law." Post Master General v. Early, 25 U.S. (12 Wheat.) 136, 148 (1827) (Marshall, C.J.).

[236] *See* Treas. Reg. § 1.263(a)-2(f), quoted at *supra* text accompanying note 219.

[237] *See* Estate of Foster v. Commissioner, 9 T.C. 930, 936 (1947).

[238] *See* Clement v. Commissioner, 30 B.T.A. 757, 762 (1934).

[239] The contribution to capital label may be necessary to settle the consequences of the transaction to the corporation. If a nonprorata contribution is not a contribution to capital within the meaning of § 118 of the Code, it may not be clear how the corporation can exclude the benefits and, if it gets an exclusion, what basis it will take for property it receives. Capitalization of the shareholder's cost does not determine how to treat the corporation.

but requires burdensome valuation of the contributed property and creates incongruities between nonprorata contributions and cases where nonrecognition of gain or loss is clear.

The *Ames* model treats a nonprorata contribution as an investment by the shareholder with respect to his stock. The shareholder adds his basis in the contributed property to his basis in retained shares without recognition of gain or loss. The only plausible motive for the contribution is that the shareholder is attempting to preserve or augment his investment in the corporation. He expects to recover the cost of his contribution through future dividends or gains or he would not have made the transfer. Over fifty years ago the courts adopted the *Ames* model for nonprorata contributions. To *Ames* they should return.