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The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries

ELLIOTT MANNING *

Introduction

This article is about the federal income tax consequences of various transactions between issuers and holders of their securities. These transactions, some relatively sophisticated corporate and financial transactions but some relatively common, include (1) a corporation's issuance of its own stock or debt instruments for property (a situation in which the tax results are relatively well settled and noncontroversial), (2) a subsidiary corporation's use of its parent's stock to acquire property or pay for services (the results of which are less well settled and more controversial), and (3) a shareholder's or partner's issuance of his or her note to acquire an equity interest in the corporation or partnership (also unsettled and controversial).

More broadly, this article is about transactions in what is here called "paper," a term meant to refer to (1) equity interests (corporate and partnership); (2) debt securities; and (3) rights to acquire stock, other equity interests, and debt securities from the issuer at some time in the future (collectively called "options"). The issuer need not be a corporation, but can also be a partnership, partner, trust, grantor, or individual—in short, anyone. The term "paper" may be somewhat misleading since the interests discussed are not always represented by a stock, bond, warrant certificate, or similar document, but it will have to do, because no better neutral term has been found.

In determining the tax consequences of some transactions of the first two of the three types mentioned above, the Service has relied on a concept sometimes called "zero basis." The concept is that stock or a note has a zero basis to the issuer and, sometimes, to the recipient. As

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1 Rights to acquire property other than the issuer's own paper raise somewhat different problems and are considered separately. For purposes of clarity, these rights are called "property options." See infra text accompanying notes 124–30.

2 Rev. Rul. 74–503, 1974–2 C.B. 117 (when a parent transfers shares of its
a consequence, a subsidiary might, for example, have a taxable gain when stock issued to it by its parent is used to acquire property, *Blackacre*, say, or to pay compensation (at least if the subsidiary does not use the stock immediately).\(^8\)

The zero bases and any resulting gain can be avoided, however, simply by reversing the order of the transactions. If a parent issues its own stock to a third party for *Blackacre*, it recognizes no gain on the exchange and takes a basis for *Blackacre* equal to its fair market value (or, if the transferor's exchange is also covered by a nonrecognition provision, the transferor's basis for the property).\(^4\) If the parent then transfers *Blackacre* to an at least 80% owned subsidiary for stock of the subsidiary, neither corporation recognizes gain on the exchange, and the basis of *Blackacre* to the subsidiary (and of the subsidiary stock to the parent) is the same as the basis of *Blackacre* to the parent.\(^5\)

The zero basis analysis, furthermore, has been applied only sporadically to other transactions between issuers and their owners and creditors. If a corporation distributes its stock as a taxable dividend to a corporate shareholder, the regulations say, the amount of the dividend is the fair market value of the stock even though the Code provides that the amount of an intercorporate distribution of property is the basis of the distributed property.\(^6\) But, if the intercorporate dividend is a transferable option to acquire property at a bargain from the distributing corporation, the Service has ruled, the amount of the dividend is zero.\(^7\) The zero basis analysis is thus applied to a distributed option created by a corporation, but not to the corporation's stock.

The zero basis concept has been applied to debt securities, specifically, to notes of shareholders contributed by them to controlled corporations in exchange for stock.\(^8\) By extension, the concept can be applied when a partner contributes his note to a partnership in exchange for a partnership interest,\(^9\) when an individual makes a gift of his note, or in any other situation where the recipient of a newly issued interest or obligation has a transferred basis in it.\(^10\)

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4 See infra text accompanying notes 51–54.

5 See infra text accompanying notes 55–60.

6 See infra text accompanying notes 108–123.

7 See infra text accompanying note 128.

8 See infra text accompanying notes 140–152.

9 See infra text accompanying note 153.

10 The Code requires a carryover basis in several contexts for property received stock to a subsidiary in exchange for the subsidiary’s stock, each corporation has a basis of zero for the stock of the other).
Differences among these fact situations may justify some of the distinctions drawn. Nevertheless, since all involve instruments created by the issuers, this strange hodgepodge of results suggests that something is wrong somewhere. It is the thesis of this article that the zero basis concept is wrong and should be abandoned. It is not only wrong in itself, but its invention was a result of a lack of a consistent analytic framework for transactions in which persons issue or retire their own paper.

The Service's rationale for the zero basis notion is that the same principles that govern transactions involving land, equipment, and stock or securities of entities other than the issuer also apply to the issuer's paper. Accordingly, a fundamental issue is whether, in a particular situation, an issuer's paper should be treated by analogy to property or as something else. If the property analogy is not used in a particular case, the further problem arises of developing some other analytic framework. Existing authority does not consistently follow any approach in cases where issuers' paper is not treated as property.

The basic idea of this article is that, whatever the character of an issuer's paper to any other holder, transactions in which that paper leaves or arrives back into the issuer's hands are not, insofar as the issuer is concerned, transactions in property. Whereas dealings in property involve each party's relationship to the property, transactions by an issuer in its own paper involve relationships between the issuer and the other party to the transaction, and should be analyzed in terms of these relationships. The property analogy is usually not helpful in this analysis, and is often downright misleading.

An issuance or retirement of debt paper is an incurrence or discharge of an obligation—typically, a borrowing of money or a repayment of a loan. Similarly, an issuance or a redemption of equity paper effects a readjustment in the capital structure of the issuer, and represents an investment or disinvestment by the holder in the issuer. Transactions in transactions in which nonrecognition of gain or loss is provided by statute. There are two related, but distinct, carryover basis situations. In one, property received in an exchange receives a basis measured by the basis of the property given up in the exchange, a substituted basis. See, e.g., I.R.C. §§ 358 (basis to distributees of stock and certain debt securities received in reorganization and incorporation exchanges), 722 (basis of contributing partner's interest), and 1031(d) (basis in like kind exchanges and similar transactions). In the other, property received in an exchange takes a basis in the hands of the recipient measured by the basis to the transferor, a transferred basis. See, e.g., I.R.C. §§ 362(a) (basis to corporation of property received as a contribution to capital by a shareholder or for issuance of stock), 361(b) (basis of property received by a corporation in a reorganization), 723 (partnership's basis for property contributed to it), and 1015 (basis of property received as a gift).

In a broad sense, the same is true of the issuance of property options.
involving option paper are usually kept open until the option expires or is exercised, at which time, the tax consequences are governed by the final transaction that results from the exercise or expiration. A failure to appreciate these concepts has led the Service to erroneous results, including the zero basis ruling referred to above and others considered in the analysis to follow.

As shown in the subsequent analysis, the property analogy does not explain well settled rules applied to issuers on the issuance and retirement of their own paper for cash or property. It does not explain the tax basis of property acquired by the issuer for its paper or the deduction allowed for services paid with stock. Nor does it explain the recognition and nonrecognition rules applied to issuers when they transfer property in exchange for their own paper on retirement, in liquidation, or otherwise.

It is further shown that the Service has taken inconsistent positions on the basis and other consequences in transactions by issuers in their own paper in carryover basis transactions, generally with related persons—such as distributions by an issuer of its paper to its shareholders, contributions by an issuer of its paper to its affiliates, and gifts—generally speaking, the transactions that have raised the zero basis question of the title. These inconsistencies are further evidence that the zero basis approach is wrong.

Finally, there is an analysis of the status of the issuer's paper in several complex situations, including transactions (1) in which gain or loss otherwise not recognized, (2) with special tax status, including installment sales, and (3) in which obligations between the two parties are terminated in connection with a transfer of property wherein assumption of liabilities is given nonrecognition or other special treatment. This analysis also shows that the property analogy sometimes produces strange results and hinders analysis. The application of the relationship approach assists in finding the proper analysis.

**Issuance and Retirement for Cash**

**Issuer**

**Equity Paper**

From the earliest days of the income tax law, it has been recognized that an issuer of stock or any other equity interest recognizes no gain or loss on issuance, regardless of the kind or amount of consideration.\(^{12}\)

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\(^{12}\) This result is now codified in §§ 1032 and 118 for corporations and § 721 for partnerships, but existed long before the enactment of those provisions. See S. Rep. No. 1622, 83d Cong., 2d Sess. 190 (1954). See generally B. BITTKER &
Similarly, the retirement of stock for cash does not result in gain or loss to the issuer, regardless of the amount paid, or the relationship between that amount and the consideration received on issuance of the retired interest. The grounds for this result are somewhat difficult to discover since, with but one exception, E.R. Squibb & Son v. Helvering, no case or ruling has been found suggesting that income might be recognized on initial issuance, or that gain or loss might be recognized on retirement.


1 If property other than cash is distributed on retirement, gain or loss may be recognized. See infra text accompanying notes 77–107.

14 The amount of the consideration received on issuance of stock was apparently relevant before 1969 if the stock is retired by the issuance of debt. See Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974) (no original issue discount on debt issued to retire preferred stock if original consideration for stock at least equal to face amount of debt; alternative holding); Gulf, Mobile & Ohio R.R. v. United States, 579 F.2d 892 (5th Cir. 1978) (original issue discount exists on debentures issued in retirement of preferred stock where amount received for each preferred share on issuance was less than the principal amount of the debenture issued in exchange, measured by the difference between the face amount of the debt and the fair market value of the stock at the time of the exchange); Cities Serv. Co. v. United States, 443 F. Supp. 392 (S.D.N.Y.), aff'd per curiam, 586 F.2d 967 (2d Cir. 1978) (original issue discount exists on exchange of debentures for preferred stock equal to the excess of (1) the face amount of the debt over the greater of (2) the fair market value of the debt or the original consideration for the stock).

The cited cases involved taxable years before 1969. The issues are framed by statute somewhat differently for taxable years after 1968. During the years 1969 through 1982, § 1232(b)(2) provided there could be no original issue discount on debt issued in reorganizations, including recapitalizations of the sort involved in the cited cases. See Rev. Rul. 77–415, 1977–2 C.B. 311 (no original issue discount on bonds issued for the issuer's stock after 1969 since the exchange is a recapitalization, and hence a reorganization, even though fully taxable to exchanging security holders).

The special rule for reorganizations was repealed for years after 1982. There can now be original issue discount on debt issued in exchange for the issuer's paper if the paper or the debt issued in exchange for it is publicly traded. In the case of new debt issued for old debt, the existence and measurement of the discount continues to be dependent on the amount received on original issuance of the old bond, if the fair market value of the old bond is less. There is, however, no special rule for new debt obligations issued for stock and, in that case, the original issue discount equals the excess, if any, of the face amount of the debt over the fair market value of the stock when exchanged. The legislative history refers only to debt for debt exchanges and consequently gives no reason for this diverse treatment.

15 98 F.2d 69 (2d Cir. 1939). This suggestion was withdrawn on rehearing, primarily for procedural reasons. See E.R. Squibb & Sons v. Helvering, 102 F.2d 681 (2d Cir. 1939).
If the property analogy were applied, an issuer would have gain or loss on issuance equal to any difference between the amount realized and its basis for the paper issued. With the possible exception of Squibb, this analysis has not been applied. Although not fully articulated, the concept applied is that an issuance of stock relates to the amount of capital invested in the issuer (in tax accounting terms, as reflected in its capital account), and thus generates no income. The issuance or retirement of equity paper increases or decreases the net assets of the entity with a corresponding change in number of proprietary shares. What happens is either that the issuer acquires new or additional owners or that existing owners modify their interests, not that property has been sold or purchased by the issuer.

The Squibb case suggests that a difference between the consideration received on issuance and the fair market value of the stock might be gross income. This is wrong. If property is purchased at arm's length for a bargain price, the bargain is not then taxed as income. If stock is issued other than at arm's length, any difference between its value and the consideration received is likely to be a gift or compensation. If so, the tax consequences should be governed by the rules for gifts and for compensation. The issuer should not be taxed on the difference.

The tax treatment of reissuances of treasury stock has been more
controversial. The first volume of the Board of Tax Appeals reports contains a case in which a corporation claimed a deduction for its loss on a reissuance of treasury stock acquired earlier at a higher price. The Board concluded that, as in the case of an original issuance of stock, no gain or loss was realized. It rejected the argument that stock, in the hands of the issuing corporation, could be property like a government or corporate security, and analyzed the reacquisition and reissuance as readjustments of the equity interests in the corporation.

Subsequently, in 1934, regulations were issued adopting the opposite position. Under those regulations, if a corporation dealt in its own shares as it might in the shares of another corporation, gain or loss was recognized on dispositions of treasury stock. This troublesome distinction, which was the source of much litigation, characterized transactions not by their economic effects, but by their appearances, that is, their supposed resemblance to dealings in property. The distinction was only eliminated with the passage in 1954 of section 1032(a), which provides that an issuer recognizes no gain or loss on receipt of consideration for its stock, whether the stock is treasury or newly issued stock. The current regulations state that the circumstances of issuance are irrelevant and specifically repudiate the pre-1954 test.

Thus, section 1032(a), as interpreted by the regulations, can be viewed as a rejection of the approach of treating stock as property in the analysis of the consequences of issuance to the issuer and an adoption of an approach that can be called relational. Every issuance or retirement of stock (or other equity) for consideration—whether on original issue or on reissue of stock previously issued and redeemed—affects the issuer's capital structure in the same way. Any prior history is ir-

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23 See T.D. 4430, XIII-1 C.B. 36 (1934). The amendment was made retroactive to 1924, but this feature was overturned in Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110 (1939). Before 1934, the regulations had, since the Revenue Act of 1918, characterized a sale of redeemed stock as a capital transaction and provided that the redemption itself produced no gain or loss to the corporation. See, e.g., Reg. 45, § 233, art. 542 (1921).
24 Cf. I.R.C. § 317(b) (stock is "redeemed" whether cancelled or held as treasury stock).
26 In E.R. Squibb & Sons v. Helvering, 98 F.2d 60, 71 (2d Cir. 1938), Learned Hand gives probably the best analysis of the underlying concepts:
If one regards the corporation as the group of its shareholders collectively, that is very apparent. If they sell "treasury shares," bought at a lower price, what really happens is that the group has been enlarged; new shareholders have been
relevant; the redemption transaction terminated the prior stockholder relationship as to the stock redeemed and reduced net assets. Any issuance of stock, whether treasury or newly issued stock, creates a new stockholder relationship and increases net assets.\(^2^7\) In the zero basis ruling, however, the Service treated the history of section 1032(a) not as a general rejection of the property analogy for the issuer's own paper, but merely as a repudiation of the distinction between treasury stock and unissued stock.\(^2^8\)

**Debt Paper**

Similar principles govern the issuance and retirement of debt securities. An issuer recognizes no gain or loss on issuance of a debt security, regardless of the amount received. Typically, the issuance is simply a borrowing of money. Any difference between the face amount and the consideration received is generally taken into account later as an interest adjustment.\(^2^9\) Thus, the difference is not recognized immediately, as it

\(^2^7\) Cf. I.R.C. § 453(e)(6)(A) (reacquisition of stock by issuer not "first disposition" for purposes of provision accelerating gain on an installment sale on a second disposition by a related buyer). This is explained as being based on the fact that because gain on a sale of treasury stock is nontaxable, its basis is irrelevant. S. Rep. No. 1,000, 96th Cong., 2d Sess. 15 (1980).

\(^2^8\) See infra text accompanying notes 131–80.

would be if the debt security were considered to be property sold by the issuer for the consideration received. Moreover, there is no suggestion that there has been a sale of zero basis property with the total consideration having to be accounted for as income.

If the amount paid to retire debt paper differs from the face amount (adjusted for unamortized issuance costs, discount, or premium), the issuer must usually recognize the difference as gross income. The gain or loss has been determined not to be capital gain or loss because there is no sale or exchange. It is difficult to see how a property analogy could be applied to a retirement, except in a two step analysis in which the debt paper is deemed purchased by the issuer and then separately extinguished—a rather strained view of a simple transaction.

An issuer's gain or loss on retirement of debt paper is an adjustment of the cost of borrowing money (or of the price of goods or services acquired

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30 Sections 108(c) and 1017 exclude this difference from gross income and, instead, reduce the issuer's basis for its property if the debt is "qualified business indebtedness," within the meaning of § 108(d)(4). Prior to 1980, the difference was excluded from gross income without any basis adjustment if it was a contribution to capital. See, e.g., Putoma Corp. v. Commissioner, 601 F.2d 734 (5th Cir. 1979) (excluding both principal and accrued interest even though the corporation had accrued and deducted interest which the shareholders had not included in income); Rev. Rul. 67–200, 1967–1 C.B. 15, clarified in Rev. Rul. 70–406, 1970–2 C.B. 16 (principal of cancelled debt is excluded from gross income as a contribution to capital; accrued interest included in gross income on the tax benefit theory). (See infra text accompanying notes 205–17 for a discussion of Putoma.) This exclusion was ended by the enactment in 1980 of § 108(e)(6), which provides that debt contributed to capital by a shareholder is deemed satisfied with a cash payment by the issuer equal to the shareholder's basis for the debt, thus causing the issuer to have cancellation of indebtedness income equal to any difference between face, as adjusted, and this basis figure (which is zero in the Putoma situation).

If the issuer is insolvent, the difference is also excluded from gross income. I.R.C. § 108(a)(1)(B), (b). Section 108(b), enacted in 1980, requires that various tax attributes, most notably, net operating loss deductions, be reduced by any amount excluded from gross income by the insolvency rule. The insolvency exclusion existed in a more generous form before the present rules were enacted in 1980. See, e.g., Kramon Dev. Co. v. Commissioner, 3 T.C. 342 (1944).

See generally Eustice, Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion, 14 Tax L. Rev. 225, 246–48, 250–51 (1959) (discussing the insolvency and the contribution to capital analyses); Luria & Donald, Cancellation of Indebtedness, Sections 108 and 1017, Tax Mgmt. (BNA) No. 88–4, at A-6-6 (contribution to capital) and A-18-19 (insolvency).

31 I.T. 2846, XVI–1 C.B. 112 (1935), superseded by Rev. Rul. 69–613, 1969–2 C.B. 163 (noting that § 1232 provides exchange treatment for the holder but does not characterize the obligor's gain or loss). But see Reg. §§ 1.163–3(c) (providing a deduction for premium on retirement), and 1.61–12(c)(3) (characterizing discount on repurchase as discharge of indebtedness income). Similar provisions go back at least to the Revenue Act of 1918. See Reg. 45, § 233, art. 44 (1921).

32 Such a strained analysis has been applied in some analogous situations. See infra text accompanying notes 202–10.
on credit), therefore, it is properly ordinary income (except possibly to the extent that it is an adjustment in price of capital assets).\(^{33}\)

### Option Paper

An amount received on a grant or issuance of an option to acquire property is not immediately recognized as income, but the theory on which nonrecognition is based is somewhat different. The basic theory is the open transaction theory: One cannot tell until the option is exercised or lapses unexercised whether the amount received is (1) a part of the selling price of the subject of the option (which will be the case if the option is exercised) or (2) a receipt of consideration without offsetting obligation (which will be the case if the option is not exercised).\(^{34}\) If the property analogy,\(^{35}\) and particularly the zero basis analysis, were applied, the entire consideration for the grant or issuance of an option would always be immediate income, without any need to await the ultimate result.\(^{36}\)

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\(^{33}\) Eustice, *supra* note 30, at 244-45. See also § 108(e)(5), which treats an adjustment of a purchase money indebtedness as an adjustment of the purchase price, not a cancellation of indebtedness, thus directly reducing the basis of the purchased property only, rather than depreciable property generally.


\(^{35}\) See *infra* text accompanying notes 124–30 for a discussion of the effect of distributions of property options.

\(^{36}\) Under the open transaction approach, when an option is exercised, the consideration initially received on issuance is added to the consideration received on exercise, and the sum is treated as the amount realized on the disposition of the subject of the option. Rev. Rul. 67–96, 1967–1 C.B. 195 (option acquired by bequest); Rev. Rul. 58–234, *supra* note 34. If the option expires unexercised, the consideration previously held in suspense is treated as ordinary income because no property has been sold. Rev. Rul. 78–182, *supra* note 34; Rev. Rul. 58–234, *supra* note 34.

On the other hand, if consideration is paid to obtain relief from an option obligation, the payment takes its character from the character of the option. If the payment exceeds the amount received on issuance of the option, for example, the excess is (1) a nondeductible capital expenditure if the subject of the option is the issuer's stock and the option is not compensatory, (2) compensation if the option was compensatory, or (3) an addition to the basis of the subject of the option if the option is a property option. Rank v. United States, 345 F.2d 337 (5th Cir. 1965) (compensatory option); Rev. Rul. 67–366, 1967–2 C.B. 165 (same). Under special rules relating to option trading, the difference between
Summary

This discussion shows that basic transactions in the issuer's paper—the issuance and retirement of equity interests and debt securities for cash—have not been treated as sales or purchases of property by the issuer. In short, there is no suggestion that section 1001 (which provides that gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis of the property) applies to the issuer in these transactions. One possible ground for this may be a recognition that its own paper is never property to the issuer. Another may be that there is no property until it is created in the issuance transaction and the property ceases to exist in the retirement transaction. Setting aside the pre-section 1032(a) history of treasury stock, the recognition, albeit implicit rather than explicit, has been that the issuance and redemption of the issuer's paper takes its character from other factors, principally, the relationship between the issuer and the other party to the transaction, usually as stockholder or creditor.

the amount paid to cancel an option and the amount received on its issuance is short-term capital gain or loss if (1) the transaction is a closing transaction (that is, a termination of the issuer's obligation under an option other than on exercise or lapse), and (2) the option covers stocks, securities, commodities, or commodity futures. I.R.C. § 1234(b). See also Rev. Rul. 78–182, supra note 34.

Substantial arguments can be made that consideration received for options to acquire the issuer's own stock or other equity should not be recognized as income or gain even if the option expires unexercised, on the ground that it is nevertheless a contribution to capital by potential equity owners. See, e.g., Commissioner v. Inland Finance Co., 63 F.2d 886 (9th Cir. 1933) (forfeited stock subscription payments are not income, in part on theory that defaulted subscriptions could be reinstated); Realty Bond & Mortgage Co. v. United States, 16 F. Supp. 771 (Ct. Cl. 1936) (forfeited payments are capital). Since 1972, however, the Service has taken the opposite position and holds that if such an option expires without exercise, income is recognized and, since there is no sale or exchange, the income is ordinary. Rev. Rul. 72–198, supra note 34. The reason for this conclusion is not clearly stated, but the ruling announcing this position implicitly rejects any concept that the transaction involves a contribution to capital. Since an exercise would have resulted in an issuance of equity, the reference to the absence of a sale or an exchange is another improper use of the property analogy. The proper question is whether there can be a contribution to capital by one who does not become a stockholder and, if so, whether the payment for an expired option is such a contribution. Section 362(c), by providing special rules for contributions to capital by nonstockholders, clearly indicates that there can be such a contribution. The ruling makes no attempt to explain why § 362 does not apply. Section 118, which excludes contributions to capital from gross income, specifically includes in the definition of "contributions in aid of construction" amounts received from any person whether or not shareholder. Section 362(c), in effect, provides for deferred recognition in the case of contributions of capital by nonstockholders by providing that the basis of contributed property is zero and requiring a reduction in the basis of other property for contributed cash. Contributions by share- holders do not have these results. If a payment for a lapsed option were considered a contribution to capital, a secondary question would be whether the
Regardless of the analysis of the issuer's situation, the investor to
whom paper is issued clearly acquires property. Whether the issuer is
a corporation, partnership, trust, or individual, and whether the paper
is equity, debt, or an option, it is property when it reaches the holder's
hands. Its basis is cost,\textsuperscript{37} or, possibly, a substituted or transferred basis.
Its holding period usually starts on the acquisition date,\textsuperscript{38} and sales or
exchanges of the paper may give rise to capital gain or loss.\textsuperscript{39}

When the paper is retired, however, the traditional perspective has
been different, in substance, adopting a relationship analysis. The Su-
preme Court held in \textit{Fairbanks v. United States} \textsuperscript{40} that because the re-
tirement of an obligation is not a sale or exchange, the holder's gain or
loss cannot be capital. While the obligation is clearly property in the
hands of the obligee, the transaction is not treated as a transfer of the
obligation qualifying as a sale or exchange, but as a redemption or pay-
ment. The analysis has been called the disappearing asset approach.\textsuperscript{41}
This is inappropriate. A disposition of a debt obligation to the issuer
leaves the holder in the same position as a disposition to a third party;
that the transaction is a redemption or payment by the issuer is irrelevant
to the holder.\textsuperscript{42}

In recognition of this, Congress has explicitly granted sale or exchange
treatment for retirements of corporate and government securities which
are capital assets and for some redemptions of stock.\textsuperscript{43} The \textit{Fairbanks}
approach is still in effect, however, where not overruled by statute.\textsuperscript{44}
Nevertheless, a number of courts have given sale or exchange treatment

\begin{thebibliography}{99}
\item\textsuperscript{37} See I.R.C. § 1012.
\item\textsuperscript{38} See I.R.C. § 1223.
\item\textsuperscript{39} See I.R.C. §§ 1221, 1222.
\item\textsuperscript{40} 306 U.S. 436 (1939). See also Hale v. Helvering, 85 F.2d 819 (D.C. Cir.
1936) (compromise of claim for less than face is bad debt, not capital loss).
\item\textsuperscript{41} See Bittker, \textit{Capital Gains and Losses—The \textquotedblleft Sale or Exchange Require-
\item\textsuperscript{42} Bittker, supra note 41, at 751–52.
\item\textsuperscript{43} I.R.C. §§ 1232(a) (1), 302(a), 331(a). For other analogous provisions, see
§§ 731(a) (partnership distribution in excess of distributee's basis treated as re-
ceived in exchange for partnership interest), and 1241 (certain amounts received
on cancellation of leases and distributorships treated as received in an exchange).
\item\textsuperscript{44} See, e.g., Breen v. Commissioner, 328 F.2d 58 (8th Cir.), \textit{cert. denied}, 379
U.S. 823 (1964) (gain on Treasury certificates is ordinary income); Ogilvie v.
Commissioner, 216 F.2d 748 (6th Cir. 1954) (satisfaction of judgment debt is
ordinary income); Rivers v. Commissioner, 49 T.C. 663 (1968), \textit{acq.} (gain on
collection of corporate notes received in a tax-free organization is ordinary in-
(loss on sale of mortgage to partnership related to debtor is capital, absent evi-

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to debt holders in dealings with obligors. Although it would be best for Congress to characterize retirements of all debt as sales and exchanges by the holders, the courts should not wait for such an amendment.

**Issuance and Retirement in In-Kind Transactions**

In the preceding discussion, all transactions have been assumed to be cash transactions. This section analyzes transactions in which property other than money is received or given by an issuer for its paper. In the first part of this section, the basis of property received by an issuer for its paper in recognition and nonrecognition transactions is discussed, again showing well recognized results to be inconsistent with a zero basis analysis. The second part of this section deals with the realization and recognition of income by an issuer when it transfers property to retire its paper.

One approach to an in-kind transaction is to view it as a split transaction—as though the paper had been issued or retired for cash equal to its fair market value and the cash had then been used to purchase or sell the property or services acquired or disposed of. This approach has appeared with some frequency in the analysis of various in-kind transactions, including the issuance or retirement by an issuer of its own paper. For example, Congress advanced this argument as a reason for the enactment of section 311(d), without explaining how it accounted for the limited scope of the provision.

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46 See, e.g., Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962) (finding a sale or exchange of certain contract rights upon their relinquishment in connection with a modification). See also Bittker, supra note 41, at 752–53.

47 An early Reagan administration tax proposal would have granted capital gain treatment to any disposition of a debt security.

48 This approach is explored in depth in W. Barnett, “Realization” In In-Kind Transactions: The Imputation of Receipts and Expenditures of Money (1978) (unpublished). Professor Barnett suggests that the theory is necessary to explain such matters as the basis of property acquired for stock and the allowance of a deduction for services paid with stock. The history cited infra at note 51 suggests this theory is not essential as an explanation.

49 It has been used in the proposed regulations under § 83. See infra text accompanying notes 159–64. The fact that the sale or exchange problem, discussed supra text accompanying notes 40–46, can be avoided by an actual two step transaction—a sale to a third party followed by a redemption from the third party—may be one reason for statutory amendments creating a sale or exchange in such circumstances.

50 See S. REP. No. 552, 91st Cong., 1st Sess. 279 (1969). See also Commis-
The rationale proves too much, however, since it could equally be applied to distributions in complete liquidation and distributions of dividends and charitable contributions, none of which is taxable. In Commissioner v. National Alfalfa Dehydrating & Milling Co., the Supreme Court dismissed a two step analysis offered by the taxpayer. There could be original issue discount on debt issued in exchange for the issuer's preferred stock, the taxpayer argued, because the effect was the same as if the bonds had been sold for cash at a price equal to the value of the stock (an amount that was less than the face amount of the debt) and the cash had been used to redeem the stock. The court rejected the argument, saying that taxation is concerned with real events, not with hypothetical equivalent transactions. Also, the split transaction approach, notwithstanding its considerable analytic appeal, does not explain a good deal of well established, if not universally accepted, statutory and case law. Accordingly, other concepts must be used to explain the results.

**Basis of Acquired Property**

*Equity Paper*

The rules governing the basis of property received upon the issuance of equity paper in transactions in which gain or loss is recognized by the transferor of the property could be viewed as an application of the property analogy rather than the relationship analysis. When property other than money (including services) is received by an issuing corporation in exchange for its own stock in a transaction which is taxable to the other party, the basis of the property acquired (or the amount deductible for the services) equals the amount realized by the other party, that is, the fair market value of the stock. This does not, however, necessarily mean that the stock is deemed property and that its issuance is payment with property. It is, rather, a recognition of the corporation as a separate entity. Even though section 1012 and its predecessors—which provide the general rule that the basis of property is cost—contain no exception or special rule for property acquired by the issuance of stock or another equity in a recognition transaction, the basis of this property need not be thought of as a cost.

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basis under section 1012. The legislative history of early revenue acts and contemporaneous rulings reveals that (1) basis was generally deemed to be fair market value on the date of acquisition, whether or not consideration was paid, and (2) it is the provision of transferred or substituted basis in nonrecognition transactions that is the special rule. Prior to the Revenue Act of 1932, for example, a transfer to a corporation as paid-in surplus or a contribution to capital in a nonrecognition transaction resulted in a fair market value basis to the corporation, except that subsequent to 1920, a carryover basis was provided for any transfer deemed to be a gift. Prior to 1921, even gifts resulted in a new fair market value basis.

In nonrecognition exchanges, the general rule might be stated to be that property received takes a basis measured by that of the property surrendered, a substituted basis. Under sections 362(b) and 722, however, property received by a corporation in exchange for stock or securities, or by a partnership in exchange for a partnership interest, takes a basis equal not to its basis for the equity interest, but to the basis of the property received in the hands of the transferor. The treatment is the same as in the case of property received by gift, where no

52 Cf. Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954) (basis of property received in a taxable exchange is fair market value of property received rather than that given up, since the value of the property received measures the amount realized).

53 See, e.g., Rosenbloom Finance Co. v. Commissioner, 24 B.T.A. 763 (1931), acq. (contribution to capital not a gift because value of stock enhanced), rev'd, 66 F.2d 556 (3d Cir.) (contribution was a gift; no suggestion basis would not be fair market value otherwise), cert. denied, 290 U.S. 692 (1933); Archibald v. Commissioner, 27 B.T.A. 837 (1933), nonacq. aff'd per curiam, 70 F.2d 720 (2d Cir.), cert. denied, 293 U.S. 594 (1934) (partner realized no taxable gain on difference between his basis in contributed property and the value of the property; gain on partnership's subsequent sale was only excess of proceeds over value when contributed); G.C.M. 2861, VII-1 C.B. 255 (1928) (basis of bonds contributed to corporation as paid-in surplus was value on date of contribution). Contra G.C.M. 10092, II-1 C.B. 114 (1932), revoked in G.C.M. 26379, 1950-1 C.B. 58.

54 See H.R. Rep. No. 350, 67th Cong., 1st Sess. 9 (1921), reprinted in 1939-1 C.B. (Part 2) 175 (stating that the provision of transferred basis for gifts is to prevent abuse).

55 See, e.g., I.R.C. §§ 358(a) (transferors to controlled corporations and exchanging shareholders in reorganizations and corporate separations), 334(c) (distributee in nonrecognition liquidation under § 333), 722 (transferor to partnership), 732 (distributee from a partnership), and 1031(d) (like kind exchanges).

56 This would be zero under the zero basis approach.

57 See I.R.C. § 1015. This principle also applies to transfers to trusts (see Reg. § 1.1015-1(a)) and from trusts (see Reg. § 1.661(a)-2(f)(3)). This latter rule is somewhat of an anomaly since a beneficiary has a basis in his interest under complex uniform basis rules that may differ from the trust's basis for the property. See Reg. § 1.1015-1(b).
consideration is given.\textsuperscript{58} These basis provisions indicate that Congress viewed the issuance of paper for property as something different from an exchange of properties. The special rules may be based on any of several assumptions, including that (1) the issuer has no basis worth taking into account, (2) the concept of basis is wholly irrelevant, or (3) the basis would otherwise be fair market value.\textsuperscript{59} Thus, the basis rules applied in these transactions reinforce the notion that the principles governing the issuer's paper are different from those that govern the disposition of other property.\textsuperscript{60}

\textsuperscript{58} The gift rules apply to donative transfers to trust. Reg. § 1.1015–1. For other transfers, a cost basis is provided in the form of a transferred basis adjusted for gain or loss recognized. Reg. § 1.1015–2.

\textsuperscript{59} In 1928, in discussing § 113(a), which is the predecessor of most of the current nonrecognition basis rules, Congress stated:

Subsection (a) of the latter section provides, in the case of certain gifts or exchanges of property, where no gain or loss results or where any gain or loss which might result is not recognized, in whole or in part, that the basis of the property shall be continued or carried over beyond the time of the gift or exchange substantially as if the gift or exchange had not occurred. The cases covered by these provisions fall roughly into two general classes: (1) Where there is a change of ownership in the property from one person to another; (2) where there is an exchange of one piece of property for another by the same person. In the first type of case it is provided that the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor; and in the other type of case, that the basis of the new property shall be the same as the basis of the old property.

H.R. REP. No. 708, 72d Cong., 1st Sess. 17–18 (1932). \textit{See also infra} note 158.

\textsuperscript{60} The difficulties generated by treating treasury stock as property for purposes of the basis rules is particularly well illustrated by Firestone Tire & Rubber Co. v. Commissioner, 2 T.C. 827, 830 (1943), \textit{acq., reviewed} (3 dis.), \textit{appeal dismissed} (6th Cir. June 19, 1944). That case held that stock of the target acquired by the acquiring corporation in exchange for treasury stock in a stock for stock reorganization took a substituted basis measured by the price at which the treasury stock had previously been purchased. The requirement that the transferor's basis be used for stock acquired by a corporation in a reorganization exchange was held not applicable since the statute only applied to stock acquired upon "issuance" of stock, which was read to mean initial issuance, not reissuance of treasury stock. \textit{See also supra} text accompanying notes 22–27. The Treasury's position at that time taxing gains on sales of treasury stock in some circumstances was heavily relied on as a rationale for the holding. Treating the issuer's paper as property thus led to a mischievous result, giving the acquired property a wholly inappropriate tax basis.

The legislative and administrative correction in this narrow area further supports the basic thesis of this article. The technical argument that the treasury stock was not "issued" was removed by a rephrasing of §§ 358(e) and 362(b) in 1968 to apply the transferred basis rule to property acquired by a corporation by the "exchange" of its stock or securities, although, arguably, the revision had been rendered unnecessary by the enactment of § 1032. The revision was made in connection with the amendment authorizing subsidiary mergers and was clearly intended to cover treasury stock as well. \textit{See S. REP. No. 1653, 90th Cong., 2d
Debt Paper

Before 1969, there was some controversy as to whether the basis of property acquired by issuing debt was the face amount of the debt or its fair market value; that is, whether there could be discount or premium when the debt has a value different from its face. A use of the fair market value of the debt as the basis of the property for which it is issued is an application of the property analogy since it applies exchange concepts. A use of the face amount, which treats the acquisition as a purchase of the property for a deferred payment obligation, is a relationship analysis because it applies tax accounting concepts.

At least since 1969, discount or premium can only arise in debt for property exchanges governed by section 1232 if the debt or the property received in exchange is a readily tradable security. If the reference were only to whether the debt is readily tradable, the rule could be taken as a finding by Congress that the property analogy should apply. The alternative reference to the marketability of the consideration received, however, makes it apparent that Congress was more concerned with proof of value than with the concept of the issuer's paper as property or not. The regulations provide that the issue price of an obligation governed by the readily tradable rule (the measure of the original issue discount), the basis of the acquired property to the issuer, and the amount realized by the recipient are all equal to the fair market value of the property received by the issuer. Thus, the property analogy is apparently applied only in those cases where the marketability exception is applicable. Presumably, other tax principles determine the consequences in other cases.

Sess. 4, reprinted in 1968–2 C.B. 851–52. It has been duplicated for pre-1968 transactions by § 1.358-4(b) of the regulations ("issuance" includes transfer of stock or securities purchased or acquired as a contribution to capital).


62 I.R.C. § 1232(b)(2); Reg. § 1.1232-3(b)(2)(iii).

63 A similar standard has been applied to holders under § 453 in determining eligibility for installment sale treatment, with obligations which are payable on demand or readily tradable being treated as immediate payment. I.R.C. § 453(f)(4). See also infra text accompanying notes 70–75 (discussing a similar position for compensatory options).

This is supported by Revenue Ruling 79–292, holding that for an accrual basis taxpayer, the amount realized on a sale of property for long-term obligations is always face value. The property analogy is specifically rejected and stated to be only applicable to cash basis taxpayers. The rejection by the Service of the property analogy for accrual basis recipients of debt paper, even though the analogy may be more appropriate for them than for issuers, indicates a fortiori that it does not apply for issuers, whether cash or accrual. The regulations indicate that the issue price, as determined under section 1232, determines the presence or absence of amortizable discount or premium for the issuer (who is not literally covered by section 1232(b)). The same result should apply in determining basis.

Thus, for debt paper, the property analogy has been rejected except in the limited cases of cash basis recipients (not issuers) and the marketability exception of section 1232.

Option Paper

No cases have been located involving property acquired for option paper. Similar issues are raised by option paper issued as compensation for services, especially options not governed by the statutory rules for qualified or restricted stock options or employee stock purchase plans.

In Commissioner v. Smith, the Supreme Court, relying in part on presumed intent, determined that the issuance of an option did not result in compensation to the recipient, but that the profit realized on exercise should instead be considered to be the compensation. Thus, the non-property, open transaction analysis was accepted. This principle is also

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65 1979–2 C.B. 287. The ruling holds that for a cash basis taxpayer, the amount realized is the fair market value of the debt.

66 Id. at 288. The special case of debt paper governed by § 1232(b)(2) is not referred to in the ruling, leaving open whether the Service believes that the statute and, particularly, the regulations relating to basis and amount realized are also confined to cash basis taxpayers.

67 The propriety of the Service's exposition in Revenue Ruling 79–292 and the parallel position of the temporary regulations under the Installment Sales Revision Act of 1980 (Reg. § 15a.453–1(d)(2)(ii)(A)) has been questioned in Meives, Revenue Ruling 79–292 and Deferred Reporting, 36 U. Miami L. Rev. 175 (1982) (fair market value of debt should govern for both cash and accrual basis taxpayer). See also Goldberg, Open Transaction Treatment for Deferred Payment Sales after the Installment Sales Revision Act of 1980, 34 Tax Law. 605 (1981) (if debt is not a cash equivalent, cash basis taxpayer should only recognize income on collection of debt, not fair market value at issue).

68 See supra text accompanying notes 37–46.


71 324 U.S. 177 (1945).
implicit in the statutory stock option rules: They do not explicitly pro-
vide for any consequence on issuance of an option, only on its exercise.\(^2\) For nonstatutory options, the open transaction principle continues to apply for purposes of determining the time and amount of compensation for both the issuer and the recipient.\(^3\) If a nonstatutory option has a readily ascertainable fair market value, however, the recipient has compensation income on receipt of the option; \(^4\) the property analogy is applied. Something like the property analogy is also applied when an option is issued as part of an investment unit with equity or debt paper: The consideration for the unit is allocated between the parts of the unit,\(^5\) with the result that if there is, for example, original issue discount involved, the discount is determined by the value assigned to the option.

Issuer's Paper as Amount Realized

**Debt Paper**

An issuer must recognize gain or loss when it distributes property in retirement of debt paper. Its amount realized in the distribution is the principal amount of the obligation, adjusted for any unamortized premium, discount, or issue costs.\(^6\)

Perhaps the extreme application of this principle is *United States v. Davis.*\(^7\) In *Davis*, one of the issues was whether a husband recognized gain or loss on a transfer of property in connection with a marital break-up, or whether the appreciation or depreciation then inherent in the property should instead be taxed to the wife on a later disposition. The Supreme Court determined gain should be recognized at the time of the transfer, deciding, in effect, that (1) the transaction was one on which gain or loss ought to be recognized, and (2) an amount realized could

\(^2\) See I.R.C. § 421.

\(^3\) Reg. §§ 1.61–15, 1.83–3(a) (2) and 1.421–6(d), (f).

\(^4\) Reg. §§ 1.83–7 and 1.421–6(c).

\(^5\) Reg. §§ 1.61–15(b) (1) (ii) and 1.1232–3(b) (2) (ii).

\(^6\) See, e.g., R. O'Dell & Sons Co. v. Commissioner, 169 F.2d 247 (3d Cir. 1948) (gain or loss recognized on foreclosure sale, even though involuntary); Freeland v. Commissioner, 74 T.C. 970 (1980) (voluntary transfer of property to creditor in satisfaction of debt secured by property is a sale). See also Reg. § 1.1001–2 (amount realized for recourse debt is adjusted principal or, if less, fair market value of property, in which case, balance is cancellation of indebtedness income).

\(^7\) 370 U.S. 65 (1962). See also International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943), which held gain was recognized on a transfer of property in payment of a bonus. There arguably was no amount realized in *International Freighting* because the services were performed before the bonus was declared and paid. The court, however, had no difficulty in finding even past services to be sufficient.
be found in even as tenous an obligation as inchoate marital property rights (which were found not to be sufficient to make Mrs. Davis a co-owner of the property). These rights were treated as a claim against Mr. Davis, and the transfer of property in satisfaction of the claim was held to be a recognition event. The inchoate rights were treated as a kind of paper. As discussed further in the next section, there may be some question of whether the claim against Mr. Davis should be considered debt paper. If it is so characterized, however, the holding in *Davis* well illustrates the principle that gain or loss results from a use of property to discharge an obligation.78

**Equity Paper**

Prior to 1954, the treatment at the corporate level of distributions of appreciated or depreciated property in redemption of stock was based on the same considerations as those relating to reissuance of treasury stock. The question was whether the transaction should be viewed as a taxable exchange of one item of property for another. The answer was clearly "No," where the corporation did not survive the redemption. At least since 1921, the regulations have provided that no gain or loss is recognized to a corporation distributing assets in liquidation.79 There has been no articulation of the grounds for this position, but it is consistent with the concept that the corporation's stock is not an amount realized by it in liquidation, at least where the liquidation transaction causes the retired stock to have no continuing meaning.

The rule was different where the stock redeemed continued to be held by the corporation. The 1934 regulation amendment 80—which taxed corporations on sales of treasury stock if they were deemed to be dealing in their own shares as they might in the shares of other corporations—also provided that a corporation which received its own stock as consideration upon a sale of property by it, or in payment of indebtedness to it, recognized gain or loss computed in the same manner as though the consideration received were property other than its stock.81 Under this rule, it was necessary to determine whether a redemption was a

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78 Cf. Rev. Rul. 67–221, 1967–2 C.B. 63 (recipient spouse in divorce recognizes no gain on receipt of property for inchoate marital rights). The ruling does not explain this conclusion. If the zero basis and exchange analysis is valid, gain should be recognized because the spouse has no basis for the property (the marital rights) given in exchange for the property received. See Mullock, *Divorce and Taxes: Rev. Rul. 67–221*, 23 U. MIAMI L. REV. 736 (1969). Under the relationship analysis, the recipient spouse has no income because the property received is a lump-sum payment not required to be included in income under § 72.

79 See Reg. 45, § 233, art. 547 (1921).

80 See supra text accompanying notes 23–28.

sale of property distributed to the redeemed shareholder or a transaction
affecting capital stock. The confusion was heightened considerably by
two other provisions: (1) The 1921 regulation which exempted from
tax distributions upon dissolution was amended in 1929 to apply to
distributions "in partial or complete liquidation" 82 and (2) the term
"partial liquidation" was defined in the statute from 1924 to 1954 to
include any distribution by a corporation in complete cancellation or
redemption of a part of its stock, whether or not accompanied by a con-
traction of business or other change at the corporate level.83 Courts
faced with these conflicting standards were forced to rely on a combina-
tion of whimsy and form in deciding cases.84

Thus, stock received by an ongoing corporation in a redemption was
sometimes treated as property or, more specifically, as an amount realized
on an exchange. In contrast, gain or loss was only recognized on a dis-
tribution of property as a dividend if the distribution was in discharge
of a liability created in a fixed dollar amount by the dividend resolution.85

In 1954, Congress put an end to most of these distinctions with the
enactment of sections 311 and 336 and the redefinition of partial liquida-
tion in section 346,86 providing nonrecognition for distributing corpora-
tions in most circumstances.87 Similar provision is now found in section

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82 See Reg. 74, § 22(a), art. 71 (1929).
84 Compare Lucius Pitkin, Inc. v. Commissioner, 13 T.C. 547 (1949) (re-
demption of all shares of one shareholder in exchange for various corporate assets
followed by issuance of an equal number of shares to remaining shareholders as
stock dividend; redemption held to be a partial liquidation; corporation not
deemed to be dealing in its own shares as it might shares of another corporation),
with Country Club Estates, Inc. v. Commissioner, 22 T.C. 1283 (1954), acq.,
reviewed (taxpayer sold subdivision lots; some sales made in exchange for its own
stock and bonds; latter transactions held to be dealings in taxpayer's stock as it
might deal in stock of another corporation, not a partial liquidation, even though
most lots disposed of in this manner; that transactions were initially reported as
sales apparently crucial).
see United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950); Commissi-
one v. Court Holding Co., 324 U.S. 331 (1945). Although General Utilities
is frequently cited as the source of this principle, the only substantive issue de-
cided by the Supreme Court in the case was that the dividend resolution before it
created no liability; there was no suggestion by the Court that gain might be re-
alized in the absence of liability, although the government had so argued in its
cert. denied, 365 U.S. 843 (1961) (gain realized on a transfer of property as
compensation; amount realized equals the deduction taken); International Freight-
ing Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943).
86 Section 346 was extensively amended in 1982. See infra note 94.
87 There are, however, many exceptions requiring recognition in what are other-
wise nonrecognition transactions, including recognition of installment gain under
731(b) for partnerships and in the regulations for trusts.88 Despite
these provisions, the pre-1954 language in the regulations distinguishing
between a redemption, on the one hand, and a sale by a corporation in
which the consideration happens to be its own stock, on the other hand,
persists under section 311.89
In 1969, with the enactment of section 311(d), Congress somewhat
reversed itself. With numerous important exceptions,90 section 311(d)
requires that a corporation recognize gain or loss on a distribution in

§ 453B, depreciation recapture under §§ 1245 and 1250, and assignment of in-
come principles. See Siegel v. United States, 464 F.2d 891 (9th Cir. 1972), cert.
denied, 410 U.S. 918 (1973) (cash basis corporation taxable on amounts payable
to it under contract, even though contract had earlier been distributed to share-
holders and shareholders received those amounts); Commissioner v. First State
Bank, 168 F.2d 1004 (5th Cir.), cert. denied, 335 U.S. 867 (1948) (distributing
bank taxable under assignment of income principles on collections of previously
charged off receivables distributed to shareholders as dividends in kind); William-
son v. United States, 292 F.2d 524 (Ct. Cl. 1961) (cash basis corporation taxed
in final return on accounts receivable distributed in complete liquidation and sub-
sequently collected by shareholder). The exceptions are so numerous that non-
recognition is largely confined to distributions of property that would produce
capital gain if sold. But cf. Rev. Rul. 77-190, 1977-1 C.B. 88 (permitting non-
recognition on a distribution of contracts representing a right to earn income even
if a sale would produce ordinary income). These provisions and cases, however,
do not rely on the property analogy, but on the concept of income recognition on
disposition even if there is no amount realized. See Manning, The Service Corpo-
ration—Who Is Taxable on Its Income: Reconciling Assignment of Income Prin-

88 Reg. § 1.661(a)–2(f)(1).
89 Reg. § 1.311–1(e) says:
Section 311 is limited to distributions which are made by reason of the corpo-
ration-stockholder relationship. Section 311 does not apply to transactions be-
tween a corporation and a shareholder in his capacity as debtor, creditor, em-
ployee, or vendee, where the fact that such debtor, creditor, employee, or vendee
is a shareholder is incidental to the transaction.

Nevertheless, in Revenue Ruling 68–21, 1968–1 C.B. 104, a corporation which
made long-term investments in stock in other corporations was allowed nonrecog-
nition on a distribution of one of those investments in exchange for its own shares.
It was not considered a vendor under the regulation, even though its primary
purpose was to dispose of the investment. The ruling concludes, for reasons not
stated, that the corporation-shareholder relationship was essential to the trans-
action. See also Rev. Rul. 80–101, 1980–1 C.B. 70 (a corporation's transfer of
stock of another corporation in exchange for its own stock and other property
in a complete liquidation of the other corporation treated as distribution covered
by the nonrecognition rule of § 311(a) to the extent of the value of its own
stock); Rev. Rul. 79–314, 1979–2 C.B. 132 (cross-redemption of preferred stocks
by two regulated corporations; each treated as making a nontaxable distribution
of the other corporation's stock, rather than as selling this stock in exchange for
its own stock).

90 The exceptions were extensively amended by § 223 of the Tax Equity and
(1982).
redemption of stock. The nonrecognition rule of section 311(a) continues to apply to other distributions, such as dividends.\textsuperscript{91} Section 311(d) does not apply to distributions in complete liquidation or to tax-free reorganizations or separations.\textsuperscript{92} The section contains exceptions for various types of major capital adjustments, including a special additional type of corporate separation,\textsuperscript{93} a distribution in partial liquidation with respect to qualified stock (that is, stock held by a noncorporate shareholder who has held at least 10\% of the corporation's stock for at least five years),\textsuperscript{94} and certain compulsory redemptions.\textsuperscript{95} Section 311(d) restores the pre-1954 notion that some distributions of property in redemption should be treated as sales. Unlike the pre-1954 approach, however, taxation appears to be based not on the purpose of a taxable distribution, but on the effect on the status of the shareholder and, to a lesser extent, on the effect on the corporation's capital structure. For example, the exception for distributions in partial liquidation applies only if the distribution is with respect to qualified stock. The effects on corporate capital structure are not related to whether the distributee was a 10\% shareholder or whether the shareholder met the five-year holding requirement for qualified stock.

Although sections 311 and 336 have more or less resolved the issue of recognition of income in connection with distributions of appreciated

\textsuperscript{91} Given that § 311(d) does not apply to an ordinary dividend distribution of property, it would seem that a redemption distribution should also be excepted if it is treated as a dividend or, more precisely, is characterized by § 301(d) as a distribution to which § 301 applies. The collateral consequences of a dividend-like redemption (the basis of the distributed property to the shareholder, for example) continue to be governed generally by the rules for dividends in kind. See, e.g., I.R.C. § 301(d). Nevertheless, it is stated in the legislative history and regulations that § 311(d) applies to a distribution in redemption whether the redemption is treated as an exchange or a dividend. S. Rep. No. 552, 91st Cong., 1st Sess. 279 (1969); Reg. § 1.311–2(a)(1). Under the TEFRA amendments, however, § 311(d) does not apply if the distributee is a corporation and the distribution is limited to the lesser of basis or fair market value. I.R.C. § 311(d)(2)(A). Also, a distribution that is made other than in redemption, but is treated as an exchange because of the absence of earnings and profits, is not subject to § 311(d). Reg. §§1.311–2(a)(1).

\textsuperscript{92} Reg. § 1.311–2(a)(2).

\textsuperscript{93} I.R.C. § 311(d)(2)(C).

\textsuperscript{94} I.R.C. § 311(d)(2)(B), (e)(1)(A). Parallel amendments extensively revised the rules for partial liquidations, limiting them to apply only to noncorporate shareholders, explicitly requiring dividend equivalence to be determined at the corporate level, and moving the rules to § 302, which deals generally with redemptions. I.R.C. § 302(b)(4), (e).

\textsuperscript{95} I.R.C. § 311(d)(2)(D), Reg. § 1.311–2(f) (redemptions to pay death taxes); I.R.C. § 311(d)(2)(E), Reg. § 1.311–2(g) (redemptions from private foundations of excess business holdings); I.R.C. § 311(d)(2)(F), Reg. § 1.311–2(h) (redemptions by regulated investment companies of redeemable stock).
property in redemption of stock, questions still are sometimes framed in terms of whether an issuer's own stock, when received in a redemption or liquidation, is an amount realized. For example, in *Tennessee Carolina Transportation, Inc. v. Commissioner*, the issue was whether the tax benefit doctrine required that a liquidating corporation recognize gross income equal to the deductions previously taken for supplies distributed in the liquidation. The distributee took a basis equal to the fair market value of the property received. It was held that the tax benefit doctrine applied, notwithstanding section 336, which provides that no gain or loss is recognized by corporations on distributions in liquidation. Many earlier cases hold that the tax benefit doctrine applies, notwithstanding section 337, when previously expensed items are sold incidental to liquidation. The taxpayer in *Tennessee Carolina* argued that the section 337 cases were distinguishable because there is a recovery in a section 337 sale incident to liquidation, but there is not in a distribution in kind under section 336. The court rejected the argument, holding that the liquidating corporation's receipt of its stock in the latter case is a sufficient recovery. The holding is reminiscent of *Nash v. United States* (which held that the tax benefit doctrine does not require a transferor in a section 351 incorporation to take a reasonable bad debt reserve into income) where the Supreme Court partly framed the question in terms of the extent of the taxpayer's recovery of the reserve.

The problem with the opinions in these cases is that by basing the reversal of deductions on the receipt of property, they tend to obscure the real issue: whether income should be recognized in a transaction in which nonrecognition treatment is normally available and, if so, why. The substantive issue the cases raise is whether a recognition of gross income under the tax benefit doctrine is necessary to clearly reflect income; that

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96 65 T.C. 440 (1975), aff'd, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979). See also Rev. Rul. 77-67, 1977-1 C.B. 33 (withdrawing acquiescence in Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963), and applying the tax benefit rule to require recognition in a liquidation in which the shareholder's basis was determined under § 334(b)(2)).


99 Conceptually similar are cases in which the assignment of income doctrine is applied to require the recognition of gross income on distributions of rights to income not yet reported. See Midland-Ross Corp. v. United States, 485 F.2d 110 (6th Cir. 1973) (distribution of contracts in progress reported on the completed contract method); Commissioner v. First State Bank, 168 F.2d 1004 (5th Cir.), cert. denied, 335 U.S. 867 (1948) (distribution of previously written off notes which have value); Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961) (distribution of accounts receivable of a cash basis taxpayer).
is, to give consistency with the original allowance of the deduction in the light of the concept of the nonrecognition provision.\footnote{A similar idea was applied in Fribourg Navigation Co. v. Commissioner, 383 U.S. 272 (1966), which held that depreciation is allowable in the year of sale even though the selling price is greater than the basis of the asset at the beginning of the year. Cf. I.R.C. \S\ 168(d)(2)(B).}

In \textit{Tennessee Carolina}, where an immediate expensing of the costs of items with a life of less than one year had been permitted primarily as a matter of administrative convenience,\footnote{See Reg. \S 1.162-3.} the deductions should have been reversed because a subsequent event—the corporation's disposition, rather than consumption, of the items—had undercut the justification for the earlier writeoff, unless provision was made for subsequent recovery or other offset by another taxpayer through a carryover of basis. Economically, the deducted costs in this situation were not expenses of the the transferor's business when they were deducted and, because of the distribution in liquidation, will not be expenses of any future period of the transferor. The costs will, instead, become expenses of the transferee's business when the items are consumed. Income is clearly reflected in this case only if the benefit of the transferor's deductions are taken away from it, and the transferee is left to deduct its newly acquired basis in the ordinary course of things.

Reasonable additions to a bad debt reserve, in contrast, are expenses properly associated with revenues of the period in which the deductions for the reserve are taken. The rationale for the deductions for these additions is not undercut if the accounts receivable associated with the reserve are transferred or distributed, rather than collected. Thus, transferor of accounts receivable should not be required to reverse its prior deductions for additions to a bad debt reserve, regardless of whether the transferee takes a carryover basis, unless the reserve is excessive.\footnote{See Revenue Rulings 78-278, 78-279, 78-280, 1978-2 C.B. 134, 135, 139, respectively, applying \textit{Nash} to liquidations under \S\S 334(b)(2) and 337 and transfers to controlled corporations under \S 351. The first two rulings (dealing with the liquidation cases) properly require inclusion in income if the fair market value of the receivables (in the case of a distribution in kind) or the amount realized on their sale that exceeds the tax basis of the receivables (that is, their face amount reduced by the reserve for bad debts). Although on the facts in the third ruling, dealing with \S 351 transfers, there is no such excess, the presence of such an excess should not require income recognition, because (1) transferred basis insures eventual recognition of the excess and (2) transfer of potential income in those circumstances is generally permissible. See Rev. Rul. 80-198, 1980-2 C.B. 113 (a corporation receiving assets subject to liabilities in a \S 351 transaction succeeds to the transferor's right to deduct payments of the liabilities if the transferor is a cash basis taxpayer and could have deducted the payments if he had made them). \textit{See} Manning, \textit{The Service Corporation—Who Is Taxable on its
This approach is consistent with that taken by the Supreme Court in *Hillsboro National Bank v. Commissioner.*\(^{103}\) The issue in the principal case before the court in *Hillsboro* was whether a liquidating corporation was required under the tax benefit doctrine to recognize as gross income an amount equal to deductions previously taken for the costs of cattle feed distributed in the liquidation. The shareholder took a basis for the feed that was determined independently of the corporation's basis. The Court held the tax benefit doctrine applied. It turned aside the taxpayer's argument that the tax benefit doctrine was inapplicable in a case, such as this, where there is no recovery. It found that a requirement of an actual recovery would neither serve the purposes of the tax benefit doctrine nor explain the cases decided under it. Further, the Court decided that the approach of *Tennessee Carolina*—finding a recovery in the liquidating corporation's receipt of its own stock—was unnatural and unnecessary. The Court simply dispensed with the need for any recovery. It held that the tax benefit doctrine applies whenever an event occurs that is "fundamentally inconsistent" with the earlier allowance of a deduction.\(^{104}\) Because the deductions at issue in the case were based on an assumption that the corporation would consume the feed and because the distribution to shareholders who took new bases for the feed was fundamentally inconsistent with this assumption, the taxpayer recognized gross income on the liquidation equal to the deductions.

More broadly, it might be argued that a corporation should recognize gain or loss on any transfer of property to its shareholders unless the transfer is encompassed by a statutory nonrecognition rule. If no nonrecognition rule applies, the argument runs, realization is the only issue. A corporation realizes gain or loss on any transfer to shareholders made in recognition of their shares and rights as shareholders, according to this argument, whether or not stock is received in exchange, and whether or not a dollar obligation is satisfied.\(^ {105}\) The corporation has transferred to the shareholders benefits equal to the fair market value of the property and has obtained from them a type of acknowledgement of the

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\(^{104}\) \(83-1\) U.S.T.C. § 9229 (1983).

\(^{105}\) \(83-1\) U.S.T.C. at 86,513.

\(^{106}\) Cf. *Commissioner v. First State Bank,* supra note 99. Also, § 311(b) contains an exception for distributions of LIFO inventory. In the case of partnership distributions, where there is normally a carryover of basis, income is nevertheless recognized if the effect of a distribution would otherwise be to shift ordinary income from partner to partner. I.R.C. § 751(b). A trust or estate recognizes gain or loss on a distribution to a beneficiary only if a fixed dollar obligation to the beneficiary is satisfied thereby. Reg. § 1.662–3(f)(3).
amount distributed. This is true since shareholders have at least inchoate rights to some dividends and have legal rights to corporate assets on liquidation.\textsuperscript{106}

Although there is much to be said in its favor, an analysis that presumes a realization in any transfer of property to shareholders proves too much because it produces results contrary to those long established and clearly sanctioned by Congress.\textsuperscript{107} In particular, it does not provide much in the way of useful guidance in dealing with transactions in which Congress has decided that nonrecognition of realized gain is appropriate. It thus seems that the propriety of imposing a corporate tax on a distribution should not be based on a technical analysis of tax rules dealing with amount realized, but should be based on an analysis derived from fundamental policies, for instance, the tax accounting policies exemplified in \textit{Nash} and \textit{Hillsboro}. The importance of this difference in approach can be illustrated by considering a partnership's distribution of previously expensed items in liquidation of a partner's interest. It is hard to find an amount realized, but is not hard to see that the tax accounting principles applied in \textit{Hillsboro} require income recognition.

\section*{Issuer's Transactions in Its Paper With Related Persons}

Many of the transactions discussed in the preceding section involve related persons—corporations and shareholders, partners and partnerships, and the like. Nevertheless, relationships generally are not factors that color the tax status of the transactions. This section deals with

\textsuperscript{106} A major difference between the \textit{Davis} situation and corporate distributions further clouds the validity of the realization approach. It was assumed in \textit{Davis} that (1) if Mr. Davis did not recognize income, Mrs. Davis would have a transferred basis, and (2) appreciation in the value of the asset before the transfer would thus be recognized on a later sale by Mrs. Davis. Where a corporation distributes property to a noncorporate shareholder as a dividend or to a corporate or noncorporate shareholder as a distribution in partial or complete liquidation, in contrast, the distributee usually takes a fair market value basis and, if no tax is imposed at that time, the corporate tax on the appreciation is forever lost. This distinction, if relevant, tends to strengthen the case for realization on a corporate distribution.

Another possible distinction, however, might point in the other direction: A shareholder already has indirect ownership of the property distributed \textit{(cf. International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943))}, whereas Mrs. Davis's inchoate marital rights were found not to be an interest in the property. This distinction is of doubtful validity as it conflicts with the fundamental principle of the separate entity of the corporation. \textit{See, e.g.,} Lynch v. Hornby, 247 U.S. 339 (1918) (dividend taxable to shareholder even if out of pre-1913 earnings since shareholder is a different entity).

\textsuperscript{107} In addition to those discussed above, these include nonrecognition of gain on charitable contributions of capital gain property. \textit{See} I.R.C. § 170(e).
transactions in which preexisting relationships are the key determinants of tax consequences.

**Distributions of Issuer's Paper to Shareholders or Other Equity Owners**

The conclusion that the issuer's paper is special in its own hands is further reinforced by the rules governing corporate distributions of that paper. The amount of a distribution of property—hence, the dividend income to the recipient if the distribution is taxable and there are ample earnings and profits—is usually the fair market value of the property.\(^8\) If the distributee is also a corporation, however, the amount of the distribution is usually the lesser of the basis of the distributed property to the distributing corporation or its fair market value, and this amount also becomes the distributee's basis for the property.\(^9\) The rules for corporate distributees are provided so that a distribution of property to a corporate shareholder cannot have the effect of stepping up the basis of distributed property for what, after the intercorporate dividends received deduction of section 243, is typically a low tax cost to the recipient.\(^10\) Nonetheless, the regulations state that if a corporation distributes its own paper to a corporate shareholder, the amount of the distribution and the basis to the distributee are deemed to be the fair market value of the paper, not any lesser basis figure.\(^11\) These rules also reinforce the notion that there is something special about distributions of a corporation's own paper.

If the distribution is taxable, earnings and profits are reduced by the fair market value of the stock distributed \(^12\) or the face amount of the debt distributed.\(^13\) On a distribution of property other than the distributing corporation's paper, in contrast, earnings and profits are reduced by the corporation's basis for the property.\(^14\) Similarly, in determining the dividends paid deduction for personal holding companies, basis, not fair market value, generally controls,\(^15\) except that the deduction is the fair market value of the distribution if it is taxable and consists of the distributing corporation's stock or debt.\(^16\) Thus, the earn-

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\(^8\) I.R.C. § 301(b)(1)(A).
\(^9\) I.R.C. § 301(b)(1)(B), (d)(2).
\(^10\) I.R.C. § 301(b)(1)(B), (d)(2).
\(^11\) I.R.C. § 312(a)(2).
\(^12\) I.R.C. § 312(a)(2).
\(^13\) I.R.C. § 312(a)(3).
\(^14\) I.R.C. § 312(a)(3).
\(^15\) I.R.C. § 312(a)(3).
\(^16\) I.R.C. § 312(a)(3).

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ings and profits and personal holding company dividend deduction provisions reinforce the idea that a corporation's own paper requires special analysis. The justification for the special provisions for this paper might be either that (1) the paper inherently has a basis equal to its fair market value (or face amount) or (2) the paper has a special status, basis is irrelevant, and fair market value is the applicable standard.\textsuperscript{117}

The rules for dividends paid in the distributing corporation's own obligations and taxable distributions of its stock apparently originated in provisions of the Revenue Act of 1936 which imposed a tax on undistributed corporate profits.\textsuperscript{118} For purposes of determining undistributed profits, a deduction was allowed for dividends paid. In the case of a dividend in the distributing corporation's paper, the deduction equaled the lower of face or value if the distribution was of the corporation's obligations (with an additional deduction for any excess of face over value upon retirement) or the stock's value if it was a taxable distribution of stock.\textsuperscript{119} Although the general undistributed profits tax was repealed in 1938,\textsuperscript{120} the dividends paid deduction continued to be allowed to special classes of corporations, including personal holding companies and those improperly accumulating earnings. The original rules defining the amount of the deduction continued until the adoption of the 1954 Code. They were replaced in 1954 with section 562, which no longer contains the particular rules for distributions of the distributing corporation's paper.

Given the purpose of the dividends paid deduction in the 1936 Act, it is surprising that the regulations did not require that shareholders recognize dividends equal to the amounts deducted by the corporation, instead, they only retained general language to the effect that dividends paid in property other than money were taxable at fair market value.\textsuperscript{121}

\textsuperscript{117} The provisions can also be explained in split transaction terms. That is, they yield the same results to the distributing corporation as would obtain if the corporation sold the paper for an amount equal to its fair market value (if it is stock) or face amount (if it is debt), and distributed the cash received to the shareholders. The split transaction approach, however, leads to results quite at odds with present law if it is applied to distributions of property other than the distributing corporation's paper. In particular, it might result in recognition of loss on these distributions.


\textsuperscript{119} Id. at § 27(d), (e). Many stock dividends were then taxable under the Supreme Court decision in Koshland v. Helvering, 298 U.S. 441 (1936). See S. Rep. No. 2156, part 2, 74th Cong., 2d Sess. 5 (1936) (minority views).

\textsuperscript{120} See S. Rep. No. 1567, 75th Cong., 3d Sess. 2 (1938).

\textsuperscript{121} See Reg. 94, § 115-10 (1936), which was unaffected by T.D. 4674, XV-2 C.B. 53 (1936), which adopted regulations relating to the corporate tax credit.
Subsequent regulations under the 1938 Act and the 1939 Code followed the same pattern.\textsuperscript{122}

The unique treatment in the dividends paid rules of distributions in the corporation’s obligations and stock—rules which had their origin in the special circumstances of the undistributed income tax—probably were applied to shareholders under the property analogy, although there is no direct explicit authority on this point. Nevertheless, the current regulations have transferred many of the principles that applied to the corporate dividends paid deduction to the determination of earnings and profits adjustments and the taxation of distributions to corporate shareholders. Treating these distributions as of fair market value for stock and face for debt is appropriate. Since the distributing corporation would not have realized income on receipt of consideration for the paper, there is no reason not to allow the corporate distributees a stepped-up basis.

If a distribution of stock is nontaxable—for example, if it is a distribution of common on common—earnings and profits are not reduced by the distribution, despite the fact that the corporation has parted with its own paper.\textsuperscript{123} This might seem to be an application of the zero basis concept, but it is not. The shareholder is not taxed because the distribution is deemed to do nothing more than to subdivide his former interest without adding to it. The earnings and profits rule is a corollary derived from the same premise; since the distribution does not enhance the shareholder’s interest, it is not a distribution of any of the corporation’s earnings.

The treatment of distributions of property options provides an interesting contrast. The effects of a distribution by a corporation of rights to acquire property from it at a specified price have been a subject of considerable controversy since Palmer v. Commissioner.\textsuperscript{124} That case held that a corporation makes no distribution when it gives its shareholders options permitting them to purchase corporate property at prices equal to fair market value when the options are distributed, even though the options appreciated substantially before they were exercised. The controversial issues have included whether, where property options have value when distributed, (1) the shareholders are deemed to receive a distribution when the options are transferred to them or only on exercise, (2) when the corporation realizes gain or loss on the disposition of the

\begin{itemize}
  \item \textsuperscript{122} See Reg. 101, §§ 27, 115 (1938); Reg. 103, §§ 19.27(e)–1, (f)–1, 19.115–10 (1939); Reg. 111, §§ 29.27(e)–1, (f)–1, 29.115–10 (1943); Reg. 118, §§ 39.27(e)–1, (f)–1, 39.115(j)–1 (1953).
  \item \textsuperscript{123} Reg. § 1.312–1(d).
  \item \textsuperscript{124} 302 U.S. 63 (1937).
\end{itemize}
property subject to the option, (3) how this gain or loss is measured and (4) the earnings and profits effects. These controversies lie largely beyond the scope of this article.

A few aspects of the government's positions on these issues are relevant, however. Generally, the regulations treat the issuance of options to employees as not being transfers for purposes of section 83, which treats certain transfers of property as compensation. Also, the Service treats property options, when issued together with other paper, as the issuer's own paper so as to qualify as nonrecognition property in certain reorganizations. If a property option is alone transferred to shareholders, however, the Service applies rules different from those that it applies to issuer paper.

Revenue Ruling 70–521 is the principal statement of the Service's position on the latter situation. There, the Service ruled that a distribution of transferable rights to shareholders is a taxable event. The amount of the distribution to a noncorporate shareholder is the fair market value of the rights when distributed, the ruling holds. Because the distributing corporation "has no basis in the rights," it further holds, the amount of the distribution to a corporate shareholder is zero, and earnings and profits are not reduced by the distribution, at least where the exercise price exceeds the corporation's basis for the option property.

The basic proposition of the ruling—that the distribution of the rights is taxable—is questionable since it runs against the usual treatment of options as open transactions. Even if this proposition is assumed to

125 See, e.g., Gibson v. Commissioner, 133 F.2d 308 (2d Cir. 1943) (proceeds of sale of options are gross income); Choate v. Commissioner, 129 F.2d 684 (2d Cir. 1942) (dividend when option exercised is equal to lesser of spread at distribution or at exercise); Tobacco Prods. Export Corp. v. Commissioner, 21 T.C. 625 (1954), nonacq. (proceeds of sale are dividend); W.G. Maguire & Co. v. Commissioner, 20 T.C. 20 (1953) (earnings and profits); G.C.M. 20563, 1947–1 C.B. 45 (proceeds of sale are income not dividend).

Reg. § 1.83–3(a)(2).


128 1970–2 C.B. 72. See also Rev. Rul. 80–292, 1980–2 C.B. 104 (extending the analysis to nontransferable options to acquire stock which was traded on a "when issued" basis).

129 As indicated above, the initial granting of an option is generally treated as an open transaction not giving rise to tax consequences until the exercise or lapse of the option. See supra notes 34–36 and 124–25. There appears to be no reason why a corporation's granting of an option to a shareholder should be different. If this approach were followed, a distribution of property options would not be taxable at all and the remaining issues would not arise. Cf. Rev. Rul. 82–197, 1982–2 C.B. 72 (writer of call to a charity entitled to deduction only on exercise); Rev. Rul. 75–348, 1975–2 C.B. 75 (same when option covers issuer's stock). But cf. Redding v. Commissioner, 630 F.2d 1169 (7th Cir. 1980) (distribution of transferrable options to purchase stock of a wholly-owned subsidiary did not qualify
valid, the propriety of the other holdings of the ruling is unclear because the grounds for distinguishing a property option (which is merely a claim on the issuer) from stock or debt securities (which are merely another type of claim) is hard to see. It is likely that the ruling was intended to prevent a corporate distributee from taking an inappropriate step-up in basis. If the amount of a distribution of a property option to a corporate shareholder equalled the fair market value of the option, the shareholder would take a basis for the option equal to this amount, notwithstanding that the dividends received deduction of section 243 would allow the distribution to be received largely or wholly tax free. This basis would become part of the basis for the option property on exercise, and the shareholder would have a fully stepped-up basis for the property. The distributing corporation, on the other hand, would not recognize the value of the option as gain or income, either when the option was distributed or when it was exercised. As a consequence, there would be a step-up in the basis of corporate property at little tax cost to the distributing corporation or the distributee.

The problem is a real one. The use of the zero basis analysis in resolving the problem, however, obscures the underlying issue of tax principle and confuses, rather than advances, understanding. The problem would be better addressed by a holding that a distribution of a property option is not a taxable event, but that shareholders are instead deemed to receive a distribution when the option is exercised equal to the difference at that time between the fair market value of the property and the option price.

Issuance to Subsidiaries or Other Controlled Entities

The foregoing analysis helps to establish the error of the zero basis position of the Service in Revenue Ruling 74–503. The ruling involves treasury stock of a parent, stock which the parent transferred to a subsidiary and which the subsidiary planned to hold, at least for the time being, rather than use immediately as consideration in an acquisition of other property. The ruling states that Congress, in enacting section 1032(a), repudiated the Tax Court's holding in *Firestone Tire & & as a tax-exempt spin-off reorganization; the issuance of the warrants was not a mere step in the distribution of the underlying stock*).

The possibility of such a step up would not exist if only the exercise of the option were a taxable event, since the step-up in basis to a corporate distributee would be limited by the excess of basis of the distributed property over the option price.

Rubber Co. v. Commissioner\textsuperscript{132} that stock of a target acquired in reorganization in exchange for treasury stock of the acquiring corporation took a basis in the latter's hands equal to its basis for the treasury stock. Also repudiated, according to the ruling, is the conceptual underpinning of the Firestone case that treasury stock usually has a basis equal to its cost, the redemption price. That the stock transferred to the subsidiary was treasury rather than previously unissued stock is irrelevant, the ruling holds. With these conclusions there is no quarrel.

The ruling continues, however, by holding that an issuer's basis for its stock, whether treasury or newly issued stock, is zero and that the subsidiary in the ruling, which by statute took a carryover basis, therefore also had a zero basis for the stock it received. The ruling cites no authority for this statement; it does not even cite the property option ruling, Revenue Ruling 70–521,\textsuperscript{133} which at least is consistent on technical grounds with the zero basis holding. Nor does it attempt to distinguish the various authorities discussed earlier in this article, most particularly, the authorities on distributions. Assume a corporation issues two shares of identical common stock, one share as a taxable dividend on preferred stock to a corporate stockholder and a second as a contribution to capital to a more than 80% owned subsidiary. The Service, for reasons undisclosed, would hold (1) the amount of the distribution of the first share and the basis of the share to the distributee equals its fair market value, notwithstanding the statutory rule that the distributing corporation's basis for property distributed to a corporate shareholder is both the amount of the distribution and the basis to the distributee unless fair market value is less, but (2) the second share has a basis equal to zero in the transferee's hands because a corporation's basis for its own stock is zero. This is an unsolved mystery.

The absence of any mention of the concept of zero basis until fairly recent times may be significant in solving the mystery of the inconsistency. Most of the rules dealing with the special status of an issuer's paper have a long history. Indeed, the history is so long that the reasons for many of the results have been lost. The concept of zero basis, in contrast, seems to have first been raised in the early to mid-1960's with the widespread use of subsidiaries to acquire property in exchange for parent stock and with the issuance on a large scale by finance subsidiaries of Eurodollar obligations exchangeable for parent stock.

There are earlier examples of triangular acquisitions involving the

\textsuperscript{132} 2 T.C. 827 (1943), acq., reviewed (3 dis.), appeal dismissed (6th Cir. June 19, 1944). (See supra note 60).

\textsuperscript{133} 1970–2 C.B. 72.
issuance of parent stock by subsidiaries. Revenue Ruling 57–278,134 for example, illustrates the use of a subsidiary to solve the creeping C reorganization problem later illustrated by the Bausch & Lomb case.135

The zero basis concept apparently extends not merely to paper like stock, warrants, and debt securities, but also to less distinct rights like a right to convert a subsidiary’s paper into parent stock,136 or possibly even a parent’s guarantee of payment of subsidiary debt or of dividends on subsidiary stock.137 The issue thus did not arise for the first time with international finance subsidiaries or triangular reorganizations. Parent guarantees of subsidiary obligations have long been commonplace. In the 1920’s and 1930’s, many utilities, railroads, and other corporations permitted subsidiaries to issue securities with a variety of parent participations.138 If anyone contended that these participations might involve gain to the subsidiaries, he left no trace of the contention.

With most other important aspects of the tax effects of the issuance of paper having been resolved, or at least under active consideration for decades, and with transactions raising the zero basis issue having oc-

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134 1957–1 C.B. 124 (acquisition by wholly owned subsidiary of assets of a corporation partly owned by the subsidiary’s parent is a valid C reorganization, even if the consideration given is stock of the parent, because the same result could be achieved by a creeping B reorganization).

135 Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir. 1959), aff’g 30 T.C. 602 (1958) (acquisition of assets by parent from 79% owned subsidiary, which then liquidated, does not qualify as a C reorganization since parent acquired 79% of assets for subsidiary stock rather than for its own stock). Cf. Rev. Rul. 67–274, 1967–2 C.B. 141 (acquisition of assets by wholly owned subsidiary which immediately liquidates qualifies as a triangular C reorganization). Compare also Rodman Wanamaker Trust v. Commissioner, 11 T.C. 365 (1948), aff’d per curiam, 178 F.2d 10 (3d Cir. 1949), which inspired the enactment of the predecessor of § 304 by upholding capital gains treatment for a shareholder’s sale of parent stock to a wholly owned subsidiary, when a redemption from the parent would have been taxed as a dividend. Section 304 specifies a transferred basis for the issuing corporation’s stock in the hands of the acquiring corporation in the brother-sister situation (I.R.C. §§ 304(a)(1), 362(a)), but not in the parent-subsidiary situation. See I.R.C. § 304(a)(2). Broadview Lumber Co. v. United States, 561 F.2d 698 (7th Cir. 1977), holds that in the latter situation the subsidiary has a cost basis in the parent stock. The failure to provide for a transferred basis to the subsidiary may be because the statute treats the distribution as coming from the parent. It may also be that Congress, contrary to the holding in Broadview, intended that the subsidiary should not be considered to have a basis in the parent stock.


137 Cf. LTR 8052018 (Sept. 23, 1980) (parent does not make contribution to capital of subsidiary by guaranteeing subsidiary debt or agreeing to issue stock in exchange for subsidiary debt; only benefit to subsidiary is lower interest rate).

138 E.g., Standard Oil Co. v. Commissioner, 11 T.C. 843 (1948) (involving consequence of honoring guarantee of dividend on preferred); Title Guarantee & Trust Co. v. United States, 41–2 U.S.T.C. ¶ 9597 (N.D. Ohio 1941) (guarantee of salary).
curred throughout the same period, it is significant that the issue rose to active controversy only recently. The Service position seems to be a revival of the view—rejected by the Congress in enacting section 1032 (a)—that an issuer can deal in its own stock or other obligations in the same manner as it does with stock or obligations of another corporation. Section 1032(a) undercuts the premise of the zero basis position. Since a parent would realize no gain on issuance of its stock or debt for cash equal to fair market value, a subsidiary receiving parent paper as a contribution to capital or in exchange for its stock should have a fair market value basis.

Revenue Ruling 74–503 is not the only authority applying the zero basis concept. It has also been applied to notes contributed by shareholders and partners to their corporations and partnerships, in particular, to notes contributed to avoid the rigors of section 357(c). Section 357(c) provides that gain is recognized on a transfer of property to a corporation in exchange for stock or securities to the extent that liabilities assumed by the corporation in the exchange exceed the transferor's basis for the transferred property. Prior to 1978, the provision was especially troublesome in the incorporation of businesses accounted for on the cash method because trade account payables were counted as liabilities, but accounts receivable had a basis of zero. Some transferors attempted to sidestep the problem by contributing their own notes to cover the difference between liabilities and the basis of other contributed property. Their theory was that such a note has a basis equal to its face amount, and its issuance thus eliminates the amount taxable under section 357(c). Following a 1968 ruling, the Tax Court held, in Alderman v. Commissioner, that issuance of the note is of no avail because the note has a cost basis, that is, basis to the issuer of zero. A better analysis might be that the issuance of the note is not the proper

139 See Raich v. Commissioner, 46 T.C. 604 (1966) (cash basis transferor realizes gain when corporate transferee assumes payables under § 357(c), which provides recognition when liabilities assumed exceed basis of assets transferred); Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972) (cash basis transferor does not realize such gain since payables of cash basis taxpayer are not “liabilities” for purposes of § 357(c)); Thatcher v. Commissioner, 533 F.2d 1114 (9th Cir. 1976) (transferor entitled to off-setting deduction to extent transferor pays assumed payables); Focht v. Commissioner, 68 T.C. 223 (1977) (Tax Court abandons Raich and follows Bongiovanni rather than Thatcher). Section 357(c) was amended in 1978, generally to follow Bongiovanni. Pub. L. No. 95–600, § 356(a), 92 Stat. 2854 (1978).


141 55 T.C. 662 (1971). See also Oden v. Commissioner, 41 T.C.M. (CCH) 1285 (1981) (contribution of partner’s note to partnership does not increase basis in his partnership interest because partner has zero basis in own note).
time to take account of the potential payment to the corporation. The court may have been unwilling to give effect to the note because there was no assurance that it would ever be paid. This is a legitimate concern in related party transactions. Historically, the courts have paid attention to this concern. In *Higgins v. Smith*, for example, the Supreme Court held that a shareholder did not realize a loss on a sale to a controlled corporation even though the sale was at fair market value because he had not made a sufficient change in his relationship to the loss property. This result is now embodied in section 267. The special issues arising from relatedness should have been faced directly in *Alderman* and the ruling it follows, rather than indirectly by a zero basis analysis.

A possible analogy is *Maher v. Commissioner*, a case in which the Service has acquiesced. In that case, a corporation assumed a liability of a shareholder. The shareholder, who gave no consideration for the assumption, remained secondarily liable, but the corporation ultimately paid the liability. The court held that the assumption was not a taxable event, instead, the payment was a distribution to the shareholder. Similarly, the issuance of a note by a shareholder to a controlled corporation might be given no tax significance, and the tax results might be left to await the shareholder's payment of the note. Such a delay in taking the note into account would be consistent with standard tax accounting concepts applied to cash method taxpayers and would avoid

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142 A somewhat analogous problem arises when shareholders in S corporations contribute notes in an attempt to increase their basis in their stock in order to take advantage of corporate operating losses. In Revenue Ruling 81–187, 1981–2 C.B. 167, the Service held that issuance of an unsecured note did not increase the shareholder's basis in the stock. The ruling states: "[S]ince A [the shareholder] incurred no cost in executing the note, its basis to A was zero," and concludes that there is no increase in basis in the stock. The ruling relies on *Perry v. Commissioner*, 54 T.C. 1293 (1970), in which a shareholder had exchanged his note for a corporate note to create a corporate indebtedness that would support a net operating loss deduction. In *Perry*, the court relied primarily on a finding that the exchange was without substance. It also stated that basis could be created only by an economic outlay by the shareholder. This appears to be the crux of the issue; when the parties are related, it is reasonable to conclude that there is no economic outlay until the note is paid. See also *Jackson v. Commissioner*, 83–1 U.S.T.C. § 9427 (9th Cir. 1983) (liability not assumed for purposes of § 357(c) upon transfer of joint venture interest subject to liabilities because transferor remained secondarily liable).

143 308 U.S. 473 (1940).

144 469 F.2d 225 (8th Cir. 1972).


146 But see Reg. § 1.1001–2(a)(4)(ii) (recourse liability of seller deemed discharged by buyer's assumption, whether or not transferor is in fact released. See also infra text accompanying note 153.

147 See *Don E. Williams Co. v. Commissioner*, 429 U.S. 569 (1977) (contribu-
the need for the erroneous zero basis analysis. It would also be consistent with the provisions in the corporate laws of many states to the effect that the giving of a note is not good consideration for the issuance of stock.\textsuperscript{148}

Neither the Alderson opinion nor the ruling it follows explain the consequences of payment of the notes held to have zero bases. If the zero basis analysis is consistently applied, a triple tax disaster emerges out of the unfortunate attempt to avoid a single one. If the corporation has a zero basis for the note, any collection is gross income, which, since the obligor is an individual, is ordinary income.\textsuperscript{149} Moreover, since the payment is in discharge of an obligation, not in exchange for stock, it apparently effects no increase in the shareholder's basis for his stock.\textsuperscript{150} If a note is issued to an S corporation or partnership for stock or as a contribution to capital,\textsuperscript{151} the income recognized by the corporation or partnership on collection is taxable, at least in part, to the shareholder or partner making the payment.\textsuperscript{152}

These absurd results are avoided if issuance of the note is treated not as a transfer of property, but as an open transaction. Payment of the note is then properly treated as a capital contribution both to the issuer (shareholder or partner) and the obligee (corporation or partnership). In short, payment of such a note should have the same consequences as payment of a stock subscription or partnership capital contribution.\textsuperscript{153} This approach also satisfies what probably was the Service's real concern—the difficult related party aspect of the transaction. That the Service's concern does not go beyond this is indirectly indicated by the numerous situations in which notes issued to third parties are given effect.

\textsuperscript{148}See, e.g., N.Y. Bus. Corp. Law § 504(b) (Consol. 1983); Model Business Corp. Act § 18 (1979).

\textsuperscript{149}Section 1232 provides sale and exchange treatment for corporate and government obligations only. But see supra text accompanying notes 40–46.


\textsuperscript{151}Delivery of notes, sometimes backed up by letters of credit, is common in tax shelter partnerships. Despite the broad attack on these partnerships, the zero basis approach has not yet been suggested and, for the reasons discussed, never should be.

\textsuperscript{152}A similar consequence may occur if the recipient is a foreign personal holding company. See I.R.C. § 551(a).

\textsuperscript{153}Cf. Prop. Reg. § 1.465–22(a)(1) (partner's amount at risk not increased by partner's note until proceeds devoted to activity); Rev. Rul. 81–278, 1981–2 C.B. 159 (partner's basis does not include liability on assumed nonrecourse note, when no demonstration that the value of the property securing the note exceeded prior claims).
Somewhat related are situations in which a transferor of property subject to a liability wishes to avoid having the liability assumed. This can arise, for example, in an installment sale of property subject to a liability in excess of basis. If the buyer assumes the liability or takes the property subject to it, the excess is treated as a payment to the seller in the year of sale. Before the Installment Sales Revision Act of 1980, this constructive payment could bar installment reporting under the rule that limited installment treatment to transactions in which the payments in the year of sale were no more than 30% of the selling price. That Act eliminated the 30% requirement, but the constructive payment increases the gain recognized in the year of sale under present law. Taxpayers often try to avoid the constructive payment by structuring sales as so-called “wraparound” transactions. In a wraparound transaction, the nominal selling price is the full value of the property, not reduced by the liability, and the seller is required to pay the wrapped indebtedness. Several cases have held that a wrapped indebtedness is deemed neither assumed nor taken subject to by the buyer if the seller's nominal retention of the liability has substance. An excess of liability

\[156\] See Hunt v. Commissioner, 80 T.C. 1126 (1983); United Pac. Corp. v. Commissioner, 39 T.C. 721 (1963); Stonecrest Corp. v. Commissioner, 24 T.C. 659 (1955). If the purchaser guarantees the debt and arranges for payment directly to the obligee, the debt is deemed assumed. Republic Petroleum Corp. v. Commissioner, 613 F.2d 518 (5th Cir. 1980); Voight v. Commissioner, 68 T.C. 99 (1977).

A similar situation arose in Revenue Ruling 79-44, 1979-1 C.B. 265, in which two unrelated individuals owning two parcels of land as tenants in common effected an exchange under which each ended up owning one parcel. The parcels were of equal value, but one was mortgaged. To compensate the individual receiving the mortgaged property for this disadvantage, the other party issued his note for one half of the amount of the mortgage. It was held, without discussion, that the issue of the note constituted a payment of boot which offset the assumption of liability for purposes of determining recognized gain under § 1031 (which makes like kind exchanges nonrecognition transactions, except to the extent of boot). Relief from a liability as a result of assumption by the transferee may be boot, but the ruling held the relief was offset by issuance of the note. Although the issue was not the basis of the note, one suspects that the fact that the note was issued to an unrelated party was powerful inducement for its recognition as immediately effective for tax purposes.

The analysis of Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972), could provide an alternative means of reaching the same result. That is, the issuance of the note could be treated not as payment, but as evidence that the party taking the property had not taken it subject to the portion of the mortgage offset by the note. The result in the ruling was less favorable to the party who received the property subject to the liability than the result that would flow from the alternative rationale. The receipt of the note was considered boot to him and was not
over basis is a constructive payment only if the liability is assumed or taken subject to. The Treasury, however, has recently adopted regulations treating any wrapped indebtedness as though it had been assumed by the buyer.\textsuperscript{157} The regulations have not yet been tested in any court.

**Proper Analysis**

The concept that an issuer’s paper in its own hands should be analyzed as being like property with a basis, holding period, and potential for yielding gain or loss on disposition is contrary to the historical treatment of that paper.\textsuperscript{158} More specifically, it is contrary to the treatment of distributions to shareholders of the distributing corporation’s paper. The conclusion that a property and zero basis analysis is not appropriate, however, does not itself provide the proper analysis for the transactions in which this analysis has been applied.

Paper of a parent transferred by it to a subsidiary should have a fair market value basis in the subsidiary’s hands. This treatment is consistent with a two transaction approach. At one point, the Treasury seemed prepared to embrace a two transaction approach to the problem. In proposed regulations under section 83 (which deals with transfers of property in connection with the performance of services), it was provided that a use of parent stock to compensate employees of a subsidiary was to be analyzed as though the parent had sold the stock to the subsidiary at fair market value and the subsidiary had then transferred the stock as compensation. The consequence was that the subsidiary would have a deduction equal to the fair market value of the stock, but neither parent nor subsidiary would have gain on their transfers of the stock.\textsuperscript{25} The final regulations, promulgated in 1978, omitted that provision, without explanation. It is understood that the omission was at the request of the Reorganizations Branch of the Service because the provision conflicted with Revenue Ruling 74–503 and because a study of the issue (as yet uncompleted) was supposedly in progress. Nevertheless, a recent ruling held that a subsidiary had no gain or loss on a transfer to its employees of stock of its parent which it received without consideration from the parent’s largest shareholder.\textsuperscript{160}

offset by the liability to which the property he received was subject. If the assumption were not treated as effective, as urged above, and the note were treated not as a note but as evidence that the liability had not been assumed, no gain would have been recognized.

\textsuperscript{157} Reg. § 15a.453–1(b)(3)(ii).

\textsuperscript{158} See W. Andrews, Federal Income Taxation of Corporate Transactions 230 (2d ed. 1979) (suggesting that the proper analysis is that a corporation has no basis for its shares, not a zero basis).


\textsuperscript{160} Rev. Rul. 80–76, 1980–1 C.B. 15; LTR 8113024 (Dec. 30, 1980) (no
The Service, furthermore, is apparently prepared to surrender a great deal of the practical effect the zero basis analysis when transactions are actually bifurcated. In a private ruling in connection with a triangular reorganization in which a subsidiary issued debt securities exchangeable for parent stock, the statement of facts included a representation that the subsidiary would pay the parent the value of that right. The subsidiary was held to recognize no gain on the issuance of the right as part of the debt securities. The ruling mentions no representation that the parent did not contribute to the subsidiary, either before or after the transaction, cash equal to the amount paid the parent. In short, there is no suggestion that a step transaction analysis might deny effect to the subsidiary’s payment of the consideration.

Moreover, recently proposed regulations provide that no gain or loss is recognized by subsidiaries on their use of parent stock in various triangular reorganizations. The preamble of the proposal justifies the result on a two step analysis, saying that the result is the same as if the parent issued its stock for the property acquired in the reorganization and then contributed it to the subsidiary. The same approach is used, in regulations proposed at the same time, to determine the basis to the parent of stock of the subsidiary received in exchange for its transfer of parent stock to the subsidiary preparatory to such a reorganization.

Although these practical solutions to the zero basis problem rob it of some of its immediacy, they leave it as a potential trap to the unwary and as a problem in any situation in which a payment to the parent is not practical or permissable. In any event, a convoluted solution to a problem that really should not exist is unsound. Revocation of Revenue Ruling 74–503 is the only appropriate response.

If the zero basis analysis is abandoned, it becomes necessary to determine the consequences of a subsidiary’s subsequent disposition of its parent’s paper. One possibility is to provide the subsidiary with a basis equal to fair market value (as in the proposed section 83 regulations,
although not necessarily with the constructive two step analysis). If the subsidiary immediately disposes of the stock or debt security, as usually happens in the circumstances described in the proposed section 83 and 1032 regulations, there is no gain or loss to the parent or subsidiary under this approach. If the subsidiary holds the stock for a period of time, it could have gain or loss on disposition.\footnote{166}

This dichotomy is illustrated by the facts of Revenue Ruling 69–265,\footnote{167} which dealt with preferred stock of a subsidiary issued in exchange for the assets of an unrelated corporation. The stock was convertible into (or, more properly, exchangeable for) stock of the parent. Two situations were posited, one in which the exchange of subsidiary stock for parent stock was to be made with the parent, and the second in which the parent was to transfer its stock to the subsidiary, so that the exchange could be made with the subsidiary.

In situation 1, the ruling holds, the subsidiary issued something other than its stock, namely, a claim against its parent, thus, the transaction was not a C reorganization because the solely for voting stock requirement was not met.\footnote{166} The other consequences of the transaction, including any consequences to the subsidiary of transferring the right it obtained from the parent, were not discussed. If the subsidiary is given a fair market value for the right, as suggested above, it has no gain or loss on the issuance of the right.

The transaction in situation 2 was a C reorganization, the ruling holds, since the subsidiary issued only a claim against itself. The ruling went on to state that the subsequent exchange would be treated as a redemption to the holder. It did not state, however, what the consequences to the subsidiary would be on using its parent stock in the redemption. Arguably, this was because it was believed that the nonrecognition rule of section 311(a) would apply. If, instead, the redemption fell within section 311(d) (which requires that a corporation recognize gain on distributions of its property in certain redemptions) and if the fair market value basis suggestion is followed, the subsidiary would have gain on the exchange equal to the excess of the value of the stock when exchanged over its value when received from the parent.

Revenue Ruling 69–265 presents a situation in which the practical

\footnote{165 \textit{ Cf. Rev. Rul. 70–305, 1970–1 C.B. 169, modified in Rev. Rul. 74–503, 1974–2 C.B. 117 (subsidiary which purchased parent stock has gain on disposition; § 1032(a) does not apply). \textit{166} 1969–1 C.B. 109. \textit{167} This holding is far from unassailable; the right to receive parent stock, being inherent and inseparable from the subsidiary’s preferred stock, could be held to be a part of that stock. \textit{See Rev. Rul. 75–33, 1975–1 C.B. 115 (special dividend rights are not boot).}}
solutions to the zero basis problem may not work. If the subsidiary
arranges for the parent to make the exchange, the transaction is not a
C reorganization, the ruling holds, even if the subsidiary, in order to
avoid the zero basis problem, pays for the value of the privilege. If the
parent transfers the stock to the subsidiary, either initially or just prior
to exercise of the exchange privilege, the issue of the subsidiary's basis
may arise. It may not be practical for the subsidiary to settle the issue
by paying fair value for the shares. A payment for the shares, furthermore,
may raise other problems, including the possibility that the payment
may be treated as a dividend under the laws of a foreign country
and thus be subject to a foreign withholding tax.

Similar problems might arise in situations of the type described in
Revenue Ruling 73–28,168 in which a subsidiary receives stock of its
parent in exchange for other property of the subsidiary. In these cases,
even if the zero basis problem is solved by actual or constructive payment
or by recognition of a basis to the subsidiary equal to fair market value
at the time received, there remains the possibility that the subsidiary may
recognize gain or loss on subsequent disposition of the paper.

Three groups that have studied the subject have concluded that this
is an improper result.169 All advocate an extension of section 1032(a)
to apply to parent stock in the hands of a subsidiary, stock which might
be called a quasi-treasury stock. Alternatively, the subsidiary's transfer
of the stock could be treated as an issuance by the parent (protected
under section 1032(a)), followed by a contribution of the proceeds to
the subsidiary.170 The proposed triangular reorganization regulations

168 1973–1 C.B. 187. Revenue Ruling 69–265, supra note 166, strongly sug-
ests that the parent stock in the hands of the subsidiary is property of the
subsidiary. This proposition was extended in Revenue Ruling 73–28, which
upheld a B reorganization in which a parent corporation acquired a second
tier subsidiary from a first tier subsidiary in exchange for its own stock. The
conclusion that the parent's stock was voting stock in this situation is particularly
hard to understand in light of the prohibition (acknowledged in the ruling)
found in many state statutes (see, e.g., DEL. CODE ANN. tit. 8, § 160(c) (1974);
N.Y. BUS. CORP. LAW § 612(b)) against a subsidiary voting stock of a parent
corporation. Cf. Rev. Rul. 72–72, 1972–1 C.B. 104 (stock held subject to an
irrevocable proxy for five years is not voting stock).

169 A.L.I., FEDERAL INCOME TAX PROJECT ON SUBCHAPTER C, 302–12 (1983);
Committees on Sales, Exchanges and Basis and Corporate-Stockholder Relation-
ships, Tax Section Recommendations No. 1980–8, 33 TAX LAW. 1543 (1980);
Committee on Corporate Taxation of the New York State Bar Association Tax
Section, Sale or Exchange by a Subsidiary Corporation of Its Parent Corporation's
Stock, 47 TAXES 146, 163 (1969).

170 This approach would make untenable the results of Revenue Rulings 69–
265, supra note 166, and 73–28, supra note 168. If in the former ruling the
parent stock is treated as issued to the preferred stockholders by the parent,
even if the subsidiary is the nominal transferor, situation 2 becomes remarkably
like situation 1. Similarly, under the approach suggested, the parent stock could
adopt the latter approach. Both approaches would avoid recognition of gain or loss, not only where the stock is acquired from the parent, but also in situations where the stock is acquired from third parties.

Another possible approach without statutory amendment is a kind of open transaction analysis derived loosely from *Maher v. Commissioner* 171 and *Higgins v. Smith.* 172 The idea is to treat a transfer of parent stock to a subsidiary as a transaction whose tax consequences are to be determined not when the subsidiary receives the stock, but only on ultimate disposition by the subsidiary. Under this approach, the subsidiary's basis in the parent stock and the parent's basis in the subsidiary stock would equal fair market value at the time of that disposition. The result is the same as if the parent had issued the stock directly to the third party and immediately transferred the consideration to the subsidiary, but the result is reached without the two step analysis. Further support for this approach can be found in *National Lead Co. v. Commissioner.* 173 That case taxed a parent on dividends received on and gain on disposition of stock of an unrelated corporation which the parent sold to the subsidiary many years before in exchange for a note.

The approach of treating a subsidiary's dealings in parent stock as parent transactions, followed by transfers from parent to subsidiary, does not comfortably apply to a subsidiary's acquisition of parent stock from a third party because subsidiaries are generally recognized as entities separate from their parents. 174 Even here, however, the subsidiary's acquisition could be conceptualized as a redemption of the stock not support a B reorganization in Revenue Ruling 73–28 and the transaction would be treated as a distribution to the parent. Since the ruling involved a wholly-owned subsidiary, there should be no recognized gain in any event. The only difference would appear to be that a distribution might carry earnings and profits, whereas a B reorganization would not. In cases of partly owned subsidiaries, the treatment as a distribution could arguably prevent qualification as a B reorganization for other shareholders. But, the Service has ruled to the contrary in Revenue Ruling 69–585, 1969–2 C.B. 56, holding the distribution did not violate the "solely for voting stock" requirement. But cf. Rev. Rul. 70–65, 1970–1 C.B. 77 (solely for voting stock requirement not satisfied where corporation, in two transactions, acquires part of another corporation's stock for stock and exchanges the balance in a nontaxable exchange in which the stock was exchanged for assets plus assumption of liabilities).

171 469 F.2d 225 (8th Cir. 1972).
172 308 U.S. 473 (1940).
173 336 F.2d 134 (2d Cir. 1964).
174 The Service expressly rejected this approach in Revenue Ruling 70–305, 1970–1 C.B. 169, in holding that where a subsidiary purchased parent stock in the open market and resold it, gain or loss was recognized on the resale. In that case, the subsidiary also received dividends on the stock, indicating that its ownership had some significance. The ruling does not indicate whether the result would be the same if local law prevented the subsidiary from receiving dividends on the stocks.
by the parent with property distributed to it by the subsidiary, followed by an issuance of parent stock to the subsidiary. The Service's attempt to tax a similar constructive distribution under the authority of section 304 has been unsuccessful.\textsuperscript{176} If the parent were to issue stock to the subsidiary in exchange for property other than cash, the issuance of the stock to the subsidiary would presumably be disregarded as a meaningless gesture under this theory, and the transaction would be treated as a distribution by the subsidiary in which the subsidiary recognizes no gain or loss under subsection 311(a). To a degree, the open transaction concept requires that the separate existence of the parent and subsidiary be disregarded, and this may be difficult to do in the light of the recent campaign by the Service to avoid treatment of controlled corporations as nominees or cost corporations in almost all circumstances.\textsuperscript{176} Furthermore, the Supreme Court has indicated that it is perhaps more willing to observe the form of a transaction than it was in earlier years.\textsuperscript{177}

All of these approaches require that the term "subsidiary" be defined. The Service has used the 80% control test of section 368(c),\textsuperscript{178} but has given no reason for doing so. Section 304 and the codification in section 267 of Higgins \textit{v.} Smith suggest that 50% would be appropriate. The latter seems better since 50% is a more realistic measure of economic control.\textsuperscript{179}

An adoption of the open transaction approach by statutory amendment would be the best solution. In view of the historical difficulty in obtaining technical amendments, further efforts by regulation, ruling, and litigation should also be pursued vigorously.\textsuperscript{180}

\textsuperscript{176} \textit{See}, \textit{e.g.}, Broadview Lumber Co. \textit{v.} United States, 561 F.2d 698 (7th Cir. 1977). The Service has acquiesced in this result. Rev. Rul. 80-189, 1980-2 C.B. 106.


\textsuperscript{177} \textit{See}, \textit{e.g.}, Frank Lyon Co. \textit{v.} United States, 435 U.S. 561 (1978). One of the factors cited in the opinion is that the transaction was a three party one, rather than a two party one.


\textsuperscript{179} Since § 368(c) defines control for purposes of § 351 as 80% ownership, the zero basis result would not usually arise in a transfer to a less than 80% owned corporation, although it could arise if the transfer were deemed a contribution to capital. \textit{Cf.} Reg. § 1.83-6(d) (treating a shareholder's transfer of stock to a corporate employee as compensation as being a contribution to capital). Tilford \textit{v.} Commissioner, 705 F.2d 828 (2d Cir. 1983) (holding the regulation to be valid and disallowing a loss on such a transfer).

\textsuperscript{180} The authors of the ALI project agree. ALI, \textit{Federal Income Tax Project on Subchapter C} 311-12 (1980).
Issuer's Receipt of Its Own Paper in Nonrecognition and Other Special Transactions

Numerous nonrecognition provisions of the Code provide special treatments for assumptions of liabilities. In a few other situations not involving nonrecognition, including installment sales, liability assumptions are also specially treated. The question considered here is whether the rules for liability assumptions should also apply when the property is the issuer's paper or the liabilities are obligations of the transferor to the transferee or of the issuer to the transferor. In these situations, the question is the degree to which statutory or other provisions designed for three party situations should be modified for transactions involving only two parties.

Issuer's Receipt of Its Own Paper as a Transfer of Property

Transactions involving readjustments among related corporations raise special problems of characterization for purposes of the nonrecognition provisions. Among these transactions are combinations of parent corporations and wholly or partly owned subsidiaries, including mergers or other transfers of property, which may be upstream (with the parent surviving under local law) or downstream (with the subsidiary surviving). They may involve parents that are holding companies with no significant assets other than their subsidiary's paper or parents that have other significant property. Particularly in the latter case, the assets of parent and subsidiary may simultaneously be transferred to a third corporation.

Downstream mergers have been held to qualify for nonrecognition as statutory mergers (A reorganizations). They have also been held to

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181 Rev. Rul. 70-223, 1970-1 C.B. 79 (downstream merger of newly purchased subsidiary); LTR 7937050 (June 14, 1979) (same).

Reorganizations are usually classified by their designations in the clauses of § 368(a)(1) as A reorganizations (statutory merger), B reorganizations (exchange of acquiring corporation voting stock for stock of the target if after the exchange the acquiring corporation has at least 80% control), C reorganizations (acquisition of substantially all of the assets for voting stock of the acquiring corporation), D reorganizations (transfer of assets to a corporation 80% controlled by the transferor's shareholders but only if the transfer is either of substantially all of the assets or qualified as a corporate separation); E reorganizations (recapitalization within a single corporation); F reorganizations (change in form, identity, or place of incorporation); G reorganizations (insolvency reorganization). There are also triangular reorganizations in which the acquiring corporation is a controlled subsidiary of the corporation whose stock is issued. These may include triangular B and C reorganizations and two special types of triangular A reorganizations (subsidiary mergers and reverse subsidiary
qualify in some cases as mere changes of identity, form, or place of incorporation (F reorganization). A tax-free liquidation under section 332 is usually an alternative means of accomplishing the same economic results for an 80% owned subsidiary, but the tax consequences of a section 332 liquidation, particularly one where basis is determined by former section 334(b)(2), may differ from those of a reorganization.

An upstream merger is treated as a liquidation, rather than as a reorganization, whereas a downstream merger is, according to Revenue Ruling 70–223, a merger, not a liquidation, even though the purpose is to avoid former section 334(b)(2). The ruling provides no rationale for permitting similar transactions to have radically different tax results. The only differences, apart from taxes, are in which corporation is deemed to be the transferor and which the survivor, matters that frequently have little consequence even under state law. The distinction is contrary to principles of horizontal equity. The acquisitive corporate reorganization area is so filled with complex, often senseless technical distinctions that form often is the only available basis for distinction, and tax results tend to be largely elective. Nevertheless, it is

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183 A liquidation under former § 334(b)(2) resulted in a step-up (or possibly a step-down) in basis and consequent depreciation and investment tax credit recaptures, whereas a downstream merger given nonrecognition treatment as an A or F reorganization avoids this result. Section 334(b)(2) was repealed in 1981. Where the parent has few assets other than its stocks in the subsidiary, a liquidation of the parent also has the same economic result, but is typically taxable to its shareholders. I.R.C. § 331(a).
184 Kansas Sand & Concrete Co. v. Commissioner, 56 T.C. 522 (1971), aff'd, 462 F.2d 805 (10th Cir. 1972) (basis determined under former § 334(b)(2) on upstream merger). See also Reg. § 1.332–2(d).
185 1970–1 C.B. 79.
186 There is, however, a long history in the reorganization area that makes the legal entity a matter of extreme importance. See, e.g., United States v. Phellis, 257 U.S. 156 (1921) (taxable gain recognized in a reorganization involving a transfer of Dupont from a New Jersey to a Delaware corporation), and Marr v. United States, 268 U.S. 536 (1925) (similar results in connection with a move of General Motors from New Jersey to Delaware).
187 See generally Pugh, Combining Acquired and Acquiring Corporations and Their Subsidiaries Following a Purchase of Stock: Some Anomalies of Form and Substance, 35 Tax L. Rev. 359 (1980).
188 See ALI, FEDERAL INCOME TAX PROJECT ON SUBCHAPTER C 62–63 (1980), which proposes that whether an acquisition results in a carryover of basis or is treated as a sale with cost bases to the parties should be made explicitly elective, rather than depending on the forms used. This approach is partly adopted by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97–248, § 224, 96 Stat. 485–90 (1982), which repealed § 334(b)(2) and
difficult to see why the choice of a downstream merger format should lead to reorganization treatment while an upstream merger format compels liquidation treatment. A more sensible approach would be either to treat as a reorganization any transaction cast as a merger under state law or to treat all parent subsidiary fusions as liquidations of the subsidiary.  

Since all transactions consummated under state merger laws qualify as A reorganizations, the determination that a downstream merger is an A reorganization can be made without deciding whether the issuer’s paper is property in its hands. Nevertheless, the use of state law designations as the basis for important tax consequences appears analogous to treating the subsidiary’s stock as property transferred to it.

Parent-subsidiary combinations not qualifying as statutory mergers sometimes directly raise the issue of whether the subsidiary’s stock is property. This is so, because a transaction can qualify as a C or a non-divisive D reorganization only if it includes an acquisition or transfer of substantially all of the property of the acquired corporation. Whether a downstream combination can so qualify initially caused a split of authority in the “General Baking” cases, all of which involved the same transaction in which a holding company transferred its assets, consisting principally of stock of an operating company, to the latter for new shares, and distributed the new shares in liquidation.  

Two courts of appeal found that a corporation could acquire its own stock and thus held satisfied the requirement of an acquisition of substantially all of the assets of the target. The other courts were unwilling to make this

substituted new § 338, making a change in the basis of assets of a newly purchased subsidiary elective without requiring a liquidation. Liquidation of the acquired corporation continued to have some significance under § 338(c)(1), which denies nonrecognition under § 337(a) to a partly purchased subsidiary except when it is liquidated.

189 Cf. Reg. § 1.1502–75(d) (2) (ii) (consolidated group remains in existence if parent assets transferred to a subsidiary).

190 Commissioner v. Whitaker, 101 F.2d 640 (1st Cir. 1939) (transaction not a C reorganization since subsidiary could not acquire its own stock, but was a transfer of part of parent’s assets to a controlled corporation and, hence, was a D reorganization); Helvering v. Kolb, 100 F.2d 920 (9th Cir. 1938) (transaction qualified as both a C and a D reorganization); Helvering v. Schoellkopf, 100 F.2d 415 (2d Cir. 1938) (transaction qualified only as controlled corporation D reorganization); Helvering v. Leary, 93 F.2d 826 (4th Cir. 1938) (transaction qualified as both types of reorganization).

191 But cf. LTR 7935115 (May 31, 1979) (a gratuitous transfer of its own shares to corporation is an indirect gift to the remaining shareholders of a future interest, relying on Revenue Ruling 71–443, 1971–2 C.B. 337, so holding for a transfer of traditional property on the basis that the remaining shareholders do not have an immediate right to possession). Since the transfer of the corporation’s own shares to it had exactly the same economic effect as a direct gift of these shares to the remaining shareholders (which is not true in Revenue Ruling
finding, but nevertheless found the transaction qualified as a transfer of part of the parent assets to a controlled corporation under the predecessor of the D definition (which at the time did not require a transfer of substantially all of the property) and thus allowed reorganization treatment. These latter courts further held that the parent assets other than the subsidiary's stock, even though relatively minor, were sufficient to make the issue of the new shares for the old (which should be considered a recapitalization) part of the reorganization exchange and therefore tax free. Thus, a small tail wagged a rather large dog.\footnote{192}

Despite the split, the Service has accepted that an issuer's stock may be property in this context, and carried the idea to truly wonderful lengths in Revenue Ruling 78–47.\footnote{193} Prior to the transaction involved in the ruling, the target owned 5\% of the stock of the acquiring corporation plus other assets apparently worth about 28\% of the target's total net assets. The target transferred the other assets for 2\% more of the transferee's stock. The exchange was held to be a C reorganization, thus enabling the target to distribute tax free not only the stock received in the exchange, but also the old 5\%. The ruling recognizes that any transfer of the old 5\% in exchange for identical shares of the acquiring corporation would have been meaningless, and holds the target is deemed to have transferred all of its assets even though the old 5\% was not transferred in fact. (This transfer was not made in order to avoid stock transfer tax.)

The ruling thus treats the transferee's stock differently from the treatment required for other property. Also, by analyzing the transaction as

\footnote{71–443}, the conclusion that the gift is of a future interest is wrong—another example of error generated by improper application of the property analogy to the issuer's own paper.

\footnote{192} Although not relied on by the courts, a possible alternative rationale could be that, although a corporation cannot "acquire" its own stock for purposes of a C reorganization, a D reorganization (at least before 1954) merely requires that the transferor "transfer" all or part of its assets. Arguably, such a transfer merely requires that the transferor make a disposition, not that there also be an acquisition by the transferee. This is a highly technical rationalization and is presented as a possible argument, not one that is being urged for adoption. Since 1954, a D reorganization requires either that there be a separation qualifying under \S\ 355 or that the corporation to which the assets are transferred acquire substantially all of the assets of the transferor. I.R.C. \S\S\ 354(b)(1), 355(a)(1), 368(a)(1)(D). Accordingly, the argument suggested would no longer be available to justify the result. In Revenue Ruling 57–465, 1957–2 C.B. 250, the Service read the "substantially all" requirement as requiring that assets only be transferred to a single corporation (thus preventing \S\ 354 from applying to divisive transactions) in holding that a downstream transfer of the General Baking type qualified as a D reorganization.

\footnote{193} 1978–1 C.B. 113.
though the old 5% had been transferred to the acquiring corporation and immediately returned to the target, the ruling took an approach inconsistent the Bausch & Lomb case.\footnote{Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 27 (2d Cir. 1959).} In that case, the parent transferred shares of its stock to a 79% owned subsidiary in exchange for the subsidiary's assets, and the subsidiary immediately returned 79% of the shares to the parent as a distribution in liquidation. The over-all effect of the transaction was that of a taxable liquidation, the court found, and must be treated as such, even though the first step literally fit into the definition of a C reorganization. The parent stock transitorily issued to the subsidiary was disregarded.\footnote{Treating the transferee's stock as being constructively transferred and returned makes a mockery of the theory of Bausch & Lomb, supra note 194, even more so than Revenue Ruling 57-278, 1957-1 C.B. 124 (interposition of a wholly owned subsidiary as corporation acquiring assets avoids liquidation and is permissible by an analogy to a creeping B reorganization), which permitted avoidance of the Bausch & Lomb result, but at least required a separate corporation and an analogy to a permissible alternative form. Neither of these requirements appears present in Revenue Ruling 78-47, nor does any equivalent factor. Also of interest is George v. Commissioner, 26 T.C. 396 (1956), acq., which involved a parent and a 50% subsidiary simultaneously transferring their assets to a third corporation. The subsidiary's stock performed double duty, serving as a parent asset transferred for purposes of qualifying the parent transfer as substantially all of the assets for stock reorganization, even though the acquiring company's stock was issued to the subsidiary for its assets (half of which acquiring company stock went to the other 50% shareholder).} A transitory issuance actually made, however, should not have less consequence than a transitory transfer only deemed to have been constructively made.

A possible justification for Revenue Ruling 78-47\footnote{This justification may also apply to George v. Commissioner, supra note 195.} is that the assets other than the subsidiary's stock, even though relatively minor, were "substantially all" of the parent's assets because operating assets were the only property that mattered. In the context of a combination of parent and subsidiary, the argument runs, the parent's shareholdings in the subsidiary should not be counted as property in applying the requirement of a transfer of substantially all of its assets.\footnote{This is apparently the view of Revenue Ruling 57-465, supra note 192. Cf. Smothers v. United States, 81-1 U.S.T.C. ¶ 9368 (5th Cir. 1981) (holding of assets which were all of the operating assets were "substantially all" in the context of liquidation-reincorporation, treated as a transfer to controlled corporation D reorganization).} The argument is consistent with the main thesis of this article, that the issuer's paper is not property to the issuer. It extends the thesis, however, to suggest that issuer's paper is not property in the hands of a holder other than the issuer, in this case, the issuer's parent. If a parent makes a
transfer in reorganization to a third corporation, subsidiary stock is taken into account in determining whether the transfer is of substantially all of its assets. If subsidiary stock is ignored in parent-subsidiary combinations, the distinction between reorganizations and liquidations is blurred practically to the point of disappearance in this context. Little more than the technical legal identity of the survivor controls the characterization of a merger of parent and subsidiary, at least in the Service's view. These technical distinctions should not be extended, at least unless it is made explicit that the taxpayer has an absolute right, by its choice of the form of the transaction, to determine whether a parent-subsidiary combination is a liquidation or a reorganization. Even this is unsatisfactory for those who are limited by nontax considerations in their selection of form. It is better to make the choice of results expressly elective.¹⁸⁸

Even if the transaction in Revenue Ruling 78–47 is treated as a reorganization, the question remains whether the old 5%—the stock of the acquiring corporation held by the target before the reorganization—can be distributed tax free to the shareholders of the target. Section 354(a) provides nonrecognition to target shareholders on an exchange of their target stock for stock of the acquiring corporation, but only if the exchange is pursuant to the plan of reorganization. The issue is whether the old stock in the ruling is received by the target shareholders in an exchange in pursuance of the plan of reorganization or is outside the plan of reorganization. If the old stock is disregarded in determining whether the transaction is a reorganization, its distribution should probably be considered outside of the reorganization.¹⁹⁰

A related question is whether a creditor's transfer of his claim to the issuing corporation in exchange for stock of that corporation can be an exchange of stock for property within the nonrecognition rule of section 351(a). Such a transfer was held to so qualify in Duncan v. Commissioner;²⁰⁰ over the objection that the transaction was a settlement of the claim rather than a transfer of property. Section 351 was amended in 1980 to provide that an indebtedness of the issuing corporation is property for purposes of section 351 only if the debt is represented by a security. The congressional intent, however, appears to have been more to insure recognition of gain or loss on such transactions than a concern for the definition.²⁰¹

¹⁸⁸ See supra note 188.
²⁰⁰ T.C. 468 (1947). See also Rev. Rul. 77–81, 1977–1 C.B. 97 (acquisition of stock by creditor not a purchase since it is governed by § 351).
Discharge of Obligations as Incident of Transfer

There has been some inconsistency in the treatment of a transfer of property in a nonrecognition transaction or installment sale in which a liability of the transferor to the transferee is extinguished by the transfer. The issue is whether the liability should be treated as assumed by the transferee or as paid by the transferor. If the liability is deemed assumed, the transfer may be wholly within a nonrecognition rule. If the transfer is considered in part to be a payment of the debt, this portion of the transaction falls within the rule that gain or loss is recognized on a transfer of property in satisfaction of a debt.

For example, in *Kniffen v. Commissioner*, in connection with a transfer of a business to a controlled corporation, a preexisting debt of the transferor to the acquiring corporation was held to be assumed for purposes of section 357(c) and then, in a separate step, discharged. The consequence was that the discharge was not considered boot and the transferor thus recognized no gain on the exchange.

In Revenue Ruling 72-464—which involved a merger into an acquiring corporation that had previously purchased the debt obligations of the target at a discount—the Service, following *Kniffen*, holds that this liability was assumed in the merger. The rule requiring recognition on a transfer of property in satisfaction of debt is held inapplicable. The ruling further holds, however, that the acquiring corporation recognized gross income equal to the unamortized discount on the debt. Section 1.331-7 of the regulations, which requires that a parent recognize as gross income unamortized discount on debt of a subsidiary to a parent when the subsidiary liquidates, was held to provide an apt analogy. In both situations, discount not taxed at the time of the transaction escapes taxation forever, an escape that is not an appropriate consequence of a nonrecognition transaction.

In *Riss v. Commissioner*, by contrast, a discharge of a liability of

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202 39 T.C. 553 (1962), acq. See also United States v. Wham Constr. Corp., 600 F.2d 1052 (4th Cir. 1979), in which a newly created subsidiary assumed a purported liability of the business being incorporated to another division of the transferor. The assumption was held to be boot. The Service does not follow *Wham*. Rev. Rul. 80-228, 1980-2 C.B. 115.

203 1972-2 C.B. 214. *But see* Rev. Rul. 76-165, 1976-1 C.B. 92 (in a liquidation, corporation recognizes gain or loss on any distribution of property which is allocable to the distributee’s interest as creditor). The latter ruling is inconsistent with the rule that gain or loss is not recognized on a transfer in a liquidation of property subject to a liability. See BITTKER & EUSTICE, supra note 12, at ¶ 11.61.

204 Riss v. Commissioner, 368 F.2d 965 (9th Cir. 1966). *See also* Rev. Rul. 70-409, 1970-2 C.B. 79 (in a liquidation under § 333, which provides for nonrecognition of gain by a shareholder except upon receipt of money or certain
the seller to the purchaser in an installment sale was considered to be a payment in the year of sale, preventing the transaction from meeting the 30% limitation in the pre-1980 version of section 453, even though an assumption by the purchaser of a third party liability would not have had this effect.

Similar questions arise in the reverse transaction, a transfer by the holder of a debt instrument to the issuer. In *Putoma Corp. v. Commissioner*, a corporation had accrued, but had not paid, interest owed to its 50% shareholder. The shareholder, who had not included the amount in income since he was on a cash basis, subsequently forgave the obligation. The court held the cancellation to be a nontaxable contribution to capital and refused to apply the tax benefit principle, which taxes recoveries of previously deducted amounts. The result was reversed by section 108(e)(6), added in 1980, which treats the transferee corporation as though the obligation had been satisfied by a cash payment equal to the shareholder's basis for the obligation.

Similarly, *Jack Amman Photogrammetric Engineers, Inc. v. Commissioner* involved a transfer of an installment obligation to the corporate obligor in a section 351 exchange. The court rejected the argument that the transaction should be treated as a "transfer" of property by the creditor under section 351 followed by a "discharge" of the liability by the acquiring corporation, a discharge in which the corporation recognized income or gain on a cancellation of indebtedness or some other theory. The court implied that the transferor, not the transferee, should recognize the income.

The Service now agrees. Revenue Ruling 73-423 holds that the seller must recognize gain under the rules for dispositions of installment obligations, notwithstanding provision in the regulations that a transfer of an installment obligation in a section 351 transaction is not a disposition triggering gain recognition. In so doing, the ruling characterized the transaction as a satisfaction of the obligation other than at face, thus distinguishing it from a transfer—a transaction within the nonrecog-

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206 601 F.2d 734 (5th Cir. 1979).
207 Section 267(b) did not bar the corporate deduction—notwithstanding the lack of inclusion in the shareholder-creditor's income—because that section applies only to more than 50% shareholders and the shareholder owned exactly 50%.
208 341 F.2d 466 (5th Cir. 1965).
209 Reg. § 1.453–9(c)(2).
tion rule of the regulations. The distinction is based on the fact that when the transfer is by the holder to the issuer, the transferee does not step into the shoes of the transferor since the obligation is cancelled. The nature of the transferor's disposition, however, does not really depend on whether the transferor is the debtor or a third party. This is another application of the disappearing property analysis for sale or exchange purposes. Since there is no statutory sale or exchange requirement in the provisions involved in transfers by the holder to the issuer, there is no excuse for extending the erroneous disappearing property analysis.

A comparison of two party transactions, of the type described, with three party transactions provides little assistance. There are technical differences and similarities: (1) The transferee steps into the transferor's shoes in a three party assumption, but not when the transferee is also the creditor, and (2) the transferor has no current receipt whether the transferee is the creditor or a third party. A listing of these differences and similarities, however, provides little help in deciding the proper results.

The analysis should start with the congressional policies for the rules providing that assumptions of liabilities in certain acquisition transactions do not cause recognition of gain, while the receipt of other property does. The basic provision was enacted in response to United States v. Hendler, which treated an assumption as a receipt of property. The stated purpose for this provision is to facilitate normal business transactions.

The decision whether recognition is appropriate should turn on whether nonrecognition fosters normal business transactions, and, in particular, on whether a failure to require recognition permits a deferral of recognition that is not consistent with the policies of the provision in question.

When only an ordinary liability is involved, the transferor remains in essentially the same position as he would be if a liability to a third party

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210 See supra text accompanying notes 41-42.
211 303 U.S. 564 (1938).
213 Specific provision for excluding assumed mortgages from the contract price in installment sales apparently first appeared in 1929. T.D. 4255, VIII-1 C.B. 165 (1929), Reg. 69, art. 44 (1929). No explanation of this rule is given, but the companion rule that a mortgage in excess of basis is considered part of the contract price and initial payment is explained in a document entitled Installment Sales Under the Revenue Acts of 1926 and 1928, reprinted in 126 REAMS, U.S. Rev. Acts 23-24 (1979), as eliminating the problem of having profit allocated to actual collections in excess of 100% since the statute provided that the income is the "proportion" of the payment that gross profit is of the contract price. The regulation was approved in Burnet v. S & L Bldg. Corp., 288 U.S. 406 (1933).
were assumed. He is freed of the obligation to pay, but receives no immediate cash. There is a technical differences in that, in the case of a third party liability, he would remain secondarily liable, whereas in the case of a liability to the transferor, the liability is immediately discharged. Since nonrecognition of gain on assumption of liabilities does not depend on this secondary liability and would not be affected by virtually simultaneous payment by the transferee, this difference does not appear to be significant. Moreover, *Crane v. Commissioner* \(^{214}\) treated a taking of property subject to a liability as equivalent to assumption, further de-emphasizing secondary liability.\(^{215}\) On balance, because the assumption rule—if it is applied to reduce basis in a nonrecognition transaction or to offset liability against basis in an installment sale—only affects time of recognition, *Kniffen* is correct and *Riss* is incorrect.\(^{216}\)

The case is somewhat different when an installment obligation or an obligation with a discount is involved because there is income that must be accounted for and it must be accounted for at the time of the transfer, if at all. The question is who should recognize the income. The approach of *Amman* and Revenue Rulings 72–464 and 73–423, choosing the one who would have recognized the income in any other circumstance, seems appropriate.

The *Putoma* situation is in between these: If the obligation were paid off, the transferor would recognize income, while if it were forgiven in a transaction not involving a contribution to capital, the issuer would recognize cancellation of indebtedness income. Section 108(e)(6) provides a reasonable compromise, treating the transferor as, in effect, having acquired the obligation on behalf of the issuer.\(^{217}\)

In any event, the better approach is one that looks to the underlying policies.

**Conclusion**

Analysis is hindered, rather than helped, by treating an issuer's paper as it enters or leaves its hands as if it were property like other property,

\(^{214}\) 331 U.S. 1 (1947). *See also* Reg. § 15a.453–1(b)(3) (equating liabilities assumed or taken subject to in installment sales).

\(^{215}\) *But see* *Maher v. Commissioner*, 469 F.2d 225 (8th Cir. 1972). In its emphasis on secondary liability, *Maher* is wrong as being inconsistent with the vast body of authority, as well as principle.

\(^{216}\) As is Revenue Ruling 70–409, *supra* note 204. The taxpayer has not had a cancellation of indebtedness since he has, in effect, received a reduced amount of property. On the same basis, Revenue Ruling 70–357, *supra* note 204, appears correct in result, but for the wrong reason.

\(^{217}\) A similar approach is provided by § 108(e)(4), which treats an acquisition of an indebtedness by a related person from a unrelated person as if it were an acquisition by the issuer for purposes of determining cancellation of indebtedness income.
with a basis, holding period, and potential for generating gain or loss. Transactions involving this paper involve more fundamental relationships, either readjustments of equity interests or the incurrence or discharge of obligations, and these property attributes are simply irrelevant to these relationships. The failure to realize this leads to absurd results like those in Revenue Ruling 74–503, finding a zero basis, and Revenue Ruling 78–47, finding a transfer of substantially all of the assets of a target corporation, notwithstanding that its principal asset—stock of the acquiring corporation—had not been transferred at all. A realization of the inappropriateness of the property analogy makes it easier to see the justification for at least a fair market value basis in the Revenue Ruling 74–503 situation and the possibility of an open transaction approach. It also makes it easier to see that in Revenue Ruling 78–47, the distribution to the target's shareholders of the stock of the acquiring corporation previously held by the target should not be considered part of the plan of reorganization.

On the other hand, the holder should, in all cases, be treated as dealing in property, whether he deals with the issuer or any other person.