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INCOME TAX BASIS AND FLORIDA REAL ESTATE

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REAL ESTATE is the staple commodity of Florida's economy, and it is consequently the subject matter of the majority of the legal practice in Florida. This fact accepted, it becomes important that the good general practitioner know all that he can know concerning the handling of real estate matters. Today, this knowing all that one can know entails a great deal more than a familiarity with deeds and mortgages and a long experience in the examination of abstracts of title. It also requires a modicum of understanding of the effect that Federal Taxation has on each step that the lawyer takes in dealing with these real estate questions.[1]

I

The purpose of this article is to discuss one phase of the application of the law of Federal Taxation to transactions concerning real property, and that phase is the broad and often overlooked subject of the basis for determining gain or loss to the taxpayer upon the sale or other disposition of the realty, in tax parlance "finding the base". The Internal Revenue Code proceeds on the

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1 This article has been written for the general practitioner in an effort to be simple and clear. There is little, if anything, here to startle or confound the expert.

premise that some part of the amount that a taxpayer either actually, as in the case of a sale, or constructively, as in the case of an exchange, receives upon the sale or exchange of property which he owns, represents the investment put into that property by him or by his predecessors in interest. This portion of the amount received is to be treated as a return of capital to the taxpayer and he is not to be taxed on this portion, but only on the difference between it and the amount that he actually or constructively receives. He may be taxed on this difference in different ways depending on the determination of questions which are not now our concern.[2] In any event, he is taxed only on this difference.

In order to determine this difference, we must first determine the portion that is not to be taxed. Determining that portion is determining the basis for tax purposes,

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[2] The rates at which the person who makes a sale or exchange would be taxed would be those provided in sections 11, 12, 13, 14 and 15 of the Internal Revenue Code, unless the property sold or exchanged were considered to be a capital asset, or property to be treated as if it were a capital asset; if the latter were true, the tax would then be imposed in the manner provided in section 117 of the Internal Revenue Code.

What constitutes a capital asset for tax purposes is not the easiest question to answer, and fortunately is not our concern here. The statutory definition of a capital asset is stated in section 117(a)(1) of the Internal Revenue Code, and if the property in question is determined to be a capital asset, the gain thereon is then subject to tax as provided in section 117, and it becomes necessary to know the basis of the property as defined in section 113 to arrive at the amount of the gain, if any, on the sale or exchange. A complete discussion of the types of property the gain or loss on which is subject to treatment under the capital gains provisions of the Internal Revenue Code may be found in 3 Mertens, Law of Federal Income Taxation, secs. 22.04 et seq. (hereinafter cited as Mertens).

If the property is not a capital asset, and it is not subject to the unusual provisions of section 117(j) dealing with property that is to be treated as if it were a capital asset, it remains equally necessary to determine the basis, since we must know how much the gain is in order to find out the amount of earned income which has been received. See Int. Rev. Code, sec. 111.

Real estate is not always a capital asset. For example, where a person is a dealer in real estate holding certain land for sale to customers in the ordinary course of his business, his gains and losses are ordinary, and are not subject to the limitations of section 117 of the Internal Revenue Code. J. O. Chapman, P-H 1944 T.C. Mem. Dec. Serv. ¶44, 173 (1944). Queensboro Corp., 46 B.T.A. 1216 (1942).

which is our problem here. Thus, when real property is disposed of by sale or otherwise, there is to some extent a return of capital, and the Commissioner of Internal Revenue, applying the Internal Revenue Code, taxes the increment over and above this return of capital. The Commissioner, in effect, says to the taxpayer, "This real estate that you have sold or otherwise disposed of represented some figure in money, in your hands, no matter how you acquired it, and I am not going to tax you on any part of that figure. If you have disposed of the property for more than that figure, you have made a gain, and I am going to tax you on the difference between that figure and the amount of money you actually or theoretically received on disposition. If you have disposed of the property for less than that figure, you have incurred a loss, and I may in some circumstances let you use the difference between that figure and the amount you actually or theoretically received as a credit against other gains that you have made."[3]

The manner in which that figure of which the Commissioner has been speaking, or the "base", is arrived at in any real estate transaction is a complicated and often a seemingly unreal procedure. No matter the complexity and lack of reality, every time that a parcel of real estate is disposed of it is necessary for someone to determine the base, immediately as to the transferor and eventually as to the transferee, in order to know how much of the proceeds of the transaction are subject to tax as gain or, as loss, may be allowed as a deduction against other gains.[4]

II

In determining the base, there are certain fundamental concepts that must first be understood. The basis provisions of the Internal Revenue Code are to be found in Section 113.[5] This section has several subsections, of which (a) and (b) are of present importance. Subsection (a) provides for the method by which one arrives at the unadjusted basis of property upon a sale or other disposition. Subsection (b) sets forth the procedure by which

3 Int. Rev. Code, sec. 117(e).

4 See Note 3, supra.

5 This section contains the entire statutory direction for determining the basis of property for tax purposes.

the unadjusted basis is adjusted to reach the figure that is actually used in order to determine the gain or loss which results from the disposition of the property. Subsection (b) provides for adjustments in the nature of capital repayments, capital expenditures, depreciation, depletion, obsolescence and amortization. Each of these provides in itself material for several papers, and the subject matter is quite technical and often of limited interest; the lawyer is infrequently required to work out these adjustments or to handle problems or answer questions concerning them. For the purpose of this discussion, then, it is proposed to consider only the unadjusted basis, and to leave for another occasion the various adjustments which must be made.

Before a consideration of the various rules by which the basis is reached in any particular situation, it is well to keep in mind that the burden of proof of establishing a basis is always on the taxpayer, and this is true no matter what the difficulties in its establishment.[6]

III

The first rule of law in dealing with a basis problem is that the cost of the property is the figure to be used as the basis in all situations save where the Internal Revenue Code specifically states to the contrary.[7] This is the general rule, and in the absence of a specified exception, is to be applied. For familiar example: A buys Blackacre, which we shall assume is a capital asset as defined in Section 117, Internal Revenue Code, for five thousand dollars, and one year later, on Miami's rising market, he sells it to a willing tourist for ten thousand dollars. The basis to A, since the transaction does not come within one of the specified exceptions in the Internal Revenue Code, is his cost of five thousand dollars, and he therefore has a gain of five thousand dollars, upon which he is taxable in this instance according to the capital gain limitations of the Internal Revenue Code.

While it is correct to say that cost is the basis to be used in all cases save those that come within the excep-

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[6] Stock Yards National Bank of South St. Paul v. Commissioner, 153 F. 2d. 708 (C.C.A., 8th, 1946). Long v. Commissioner, 96 F. 2d. 270 (C.C.A., 9th, 1938), Cert. Den. 305 U. S. 616, 83 L. Ed. 392 (1938).

[7] The language of Int. Rev. Code, sec. 113(a) so states.

tions enumerated in the Internal Revenue Code, there are some problems involved in the determination of cost, which apply to real estate transactions. One typical situation in Florida is that of the real estate subdivider or developer who buys several acres of land which he then divides into lots and sells by lots. Under the applicable cases,[8] this taxpayer is required to determine the cost price of each lot sold and to report the gain or loss thereon in the year in which the particular lot is sold. The allocation ultimately made need not be by area alone, but may consider location, assessed valuation of the local tax assessor, front feet, tentative sale price and any other legitimate qualifying factors.[9] This allocation of cost will be approved, provided reasonable grounds of the kind here enumerated are used.[10]

Where the taxpayer acquires the land in a condemnation proceeding, the rule for determining the cost, and thus the basis, is stated by the Bureau of Internal Revenue to be that the condemnation award plus the award for severance damages to, and a special benefit assessment against, the remaining part of the affected real estate make up one proceeding and must be considered as a unit in determining the basis to the taxpayer upon his subsequent sale or exchange.[11]

If one purchases improved real estate with the intention to tear down part of the building in order to improve it, the cost of the demolition must be added to the original purchase price to reach the basis.[12] However, the intention to rebuild must be present at the time that the purchase is made.[13]

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8 National Memorial Park, Inc. v. Commissioner, 145 F. 2d. 1008 (C.C.A., 4th, 1944), D.S. Clarke, 22 B.T.A. 314 (1931). U. S. Treas. Reg. 111, sec. 19.22(a)-11.

9 Biscayne Bay Islands Co., 23 B.T.A. 731 (1931). Rosemont Co., 18 B.T.A. 200 (1929).

10 Hannibal Missouri Land Co., 9 B.T.A. 1072 (1928). J.S. Cullinan, 5 B.T.A. 996 (1927), aff'd. in effect at 19 B.T.A. 930 (1930). I.T. 1843, II-2 Cum. Bull. 72.

11 Commissioner v. Estate of Appleby, 123 F. 2d. 700 (C.C.A., 2d., 1941). G.C.M. 20322, 1938 Cum. Bull. 167.

12 G.C.M. 23698, 1943 Cum. Bull. 340.

13 U.S. Treas. Reg. 111, sec. 19.23(e)-2, Providence Journal Co. v.

Of interest to real estate buyers in a community where fôreclosures are as frequent as they are in Florida is the consideration of the basis of property acquired by foreclosure. When the mortgagee buys in the property at the master's sale, his basis is the amount bid for the property, which is assumed to be the fair market value at the time of acquisition; however, if it appears that the fair market value of the property is not the same as the bid price, the fair market value will be used to establish the basis.[14] Suppose the taxpayer sells the property at a profit and takes back a purchase money mortgage which he later forecloses and thereby reacquires the property. It is held, first, that the profit on the original sale, which is treated as a completed transaction, is taxable income; and, second, that the price paid on repurchase at the foreclosure sale is the new basis in a transaction which is entirely separate from the original sale.[15]

Property almost always comes mortgaged in Florida. What is the basis of real estate on which there is a mortgage, and does it matter whether the taxpayer took the property subject to the mortgage or assumed and agreed to pay it? Prior to the recent decision in the case of Crane v. United States,[16] the above question was another of the many unanswered ones in the tax law. The law formerly seemed to be that one who took real property subject to a mortgage could not add to the actual cash consideration the amount of the mortgage; but if he assumed and agreed to pay the mortgage, then he was compelled to add it to the actual cash consideration in order to arrive at his tax basis.[17] The Commissioner of Internal Revenue never cared for this rule and actively litigated to have it changed; his persistence finally succeeded, when the

Broderick, 25 F. Supp. 940 (D.C., R.I., 1938), aff'd. 104 F. 2d. 614 (C.C.A., 1st, 1939).

14 U.S. Treas. Reg. 111, sec. 29.23(k)-3. James J. Reilly, 46 B.T.A. 1246 (1942). Carolyn H. Snell, P-H 1944 T.C. Mem. Dec. Serv. ¶42,401 (1944). See 3 Mertens, sec. 21.10 (1942), wherein the rule to the effect that the basis is the fair market value is stated and discussed.

15 Jacob M. Dickinson, Jr., et al, Exec'r., 18 B.T.A. 790 (1930). Edward S. Phillips, 9 B.T.A. 1016 (1927).

16 91 U.S. Sup. Ct., L. Ed. 931 (April 14, 1947) (advance sheet).

17 United States v. Hendler, 303 U.S. 564, 82 L. Ed. 1018 (1938).

Supreme Court affirmed the Circuit Court of Appeals which had reversed the Tax Court in the case of Crane v. United States.[18] Here, the question was squarely presented and the decision squarely handed down. It now makes no difference whether the mortgage is assumed by the taxpayer, or whether he simply takes subject to it. To establish his basis, he must add the amount of the mortgage due at the time of the sale to the amount that he actually pays, and this is true in order to arrive at his basis for purpose of depreciation as well as for the purposes of resale or exchange.[19] Upon resale, of course, it follows that he adds the amount then due on the mortgage to the actual consideration he receives to reach the amount which he realizes on the sale.

It may sometimes be necessary to point out to the purchaser of real estate that he may not allocate his cost among the several possible estates, easements and profits in land, but must apply his cost, or basis, to the fee simple absolute title which he buys.[20]

Upon occasion, one encounters the situation where the taxpayer acquired real estate for cash plus a promise to support the grantor during the remainder of the grantor's life. Here, the Bureau of Internal Revenue has ruled that the taxpayer may add the value of these payments for support to his original cash outlay to arrive at his basis.[21] Also, there is still much recently homesteaded land in some counties in Florida, and the rule to be applied where property has been acquired by homesteading is that the basis is the fair market value at the date of acquisition of the homestead.[22]

All rules concerning basis are subject to one qualification, which has to do with the time of acquisition. If the property, the basis of which is to be determined, was acquired prior to March 1, 1913, no matter how it was

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18 See Note 16, supra.

19 Crane v. United States, 91 U.S. Sup. Ct., L. Ed. 931, at 935 (April 14, 1947) (advance sheet).

20 Searles Real Estate Trust, 25 B.T.A. 1115 (1932). William Robert Farmer, 1 B.T.A. 711 (1925).

21 G.C.M. 11655, X-II Cum. Bull. 160.

22 O.D. 386, II Cum. Bull. 33. See also 3 Mertens, sec. 21.34 (1942).

acquired, its basis is either the basis otherwise arrived at in the manner set forth in the applicable subsection of Section 113, Internal Revenue Code, or it is the fair market value of the property as of March 1, 1913, whichever is the greater.[23] This rule is for the purpose of establishing gain only. If there has been a loss, the fact that the property was acquired prior to March 1, 1913, would be of no consequence, and the loss would be computed in the usual way by using the cost as of the date of acquisition as the basis.

The phrase, "fair market value", as distinguished from cost", is a key one in discussing the basis of property, for it may have to be used in any type of situation. Fair market value has been judicially defined as the price at which a willing buyer would buy and a willing seller would sell.[24] The simplicity of the definition is misleading as the great number of valuation problems that have required litigation will indicate. However, for present purposes, it is necessary merely to point out that the value at which the real estate is returned for estate tax purposes has been held to determine prima facie the fair market value of the property for basis purposes, in a decedent's estate.[25] The presumption is, of course, rebuttable by other evidence.[26]

IV

With the above survey of the general rule, it is now timely to consider the various exceptions to this rule as they may arise in real estate transactions. Perhaps first in importance among these is the treatment as to basis accorded to property acquired by "bequest, devise or inheritance".[27] The principles here applicable are distinct

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23 Int. Rev. Code, sec. 113(a)(14). U.S. Treas. Reg. 111, sec. 29.113(a)-1 and 2, as amended by T.D. 5402, Sept. 5, 1944. For a list of decisions where the fair market value of real estate was determined by litigation, see P-H Fed. Tax Serv., ¶ 10588 (1947).

24 Union National Bank of Pittsburgh et al., Exec'rs. v. Driscoll et al., 32 F. Supp. 661 (D.C., Pa., 1940). Wood, Adm'r. v. United States, 29 F. Supp. 853 (C. Cls., 1939).

25 Charles Bertram Currier, 7 T.C. 980 (1946). Elizabeth J. Bray, Adm'r., 4 B.T.A. 42 (1926).

26 Elizabeth G. Augustus, 40 B.T.A. 1201 (1939). Edwards v. Douglas, 269 U.S. 204, 70 L. Ed. 235 (1925).

27 This is the language of Int. Rev. Code, sec. 113(a)(5).

unto themselves. The Internal Revenue Code provides in general that the basis of property thus acquired shall be the fair market value of the property at the time of acquisition.[28] From the inference of the language used in the Internal Revenue Code, and from the Regulations[29] issued pursuant thereto, it is clear that the "time of acquisition" means either the date of the decedent's death from whom the property is acquired, or, in cases where the optional valuation date is used for Estate Tax purposes as permitted by Section 811(j) of the Internal Revenue Code, one year after the date of the decedent's death.[30] Thus, the basis of property acquired by devise or inheritance is the fair market value of the realty either at the date of the death of the decedent or one year thereafter.[31] There is a third possible date on which the property may have to be valued to determine its basis in the hands of the devisee or heir. If the personal representative of a decedent's estate elects the optional valuation date, and then sells, disposes of, or distributes the property on a date less than one year after the decedent's death, then the basis is the fair market value at the time the property is sold, disposed of, or otherwise distributed.[32]

This doctrine is simple enough on casual inspection, but there are several questions lurking in the language. Leading among them is whether this rule for determining basis is to be applied to property taken by a contingent as well as a vested remainderman. The answer, as stated in the case of Helvering v. Reynolds,[33] is now in the affirmative,

28 See Note 27, supra.

29 U.S. Treas. Reg. 111, sec. 29.113(a)(5)-1.

30 In 1942, the Internal Revenue Code was amended by adding to sec. 113(a)(5) language providing that where an executor elects to use the date one year after the date of decedent's death as the date for the evalution of the decedent's estate, as he is permitted to do by Int. Rev. Code, sec. 811(j), then the time of acquisition for basis purposes shall be this optional valuation date. Thus, if the executor so elects, the fair market value of the property acquired by bequest, devise or inheritance is determined one year after the date of decedent's death.

31 See supra in this article, for a discussion of the phrase "fair market value".

32 Int. Rev. Code, sec. 113(a)(5) and sec. 811(j). U.S. Treas. Reg. 111, sec. 29.113(a)(5)-1-b-3. U.S. Treas. Reg. 105, sec. 81.11.

33 313 U.S. 428, 85 L. Ed. 1438 (1941).

and to the effect that it makes no difference whether the estate is contingent or vested, present or future, the basis is to be determined in the same manner, and the date of acquisition for valuation purposes is the date of the decedent's death or one year thereafter at the option of the personal representative. This result was reached, however, only after protracted litigation and much difference of opinion.[34]

As a necessary ramification of the decision in Helvering v. Reynolds, it is now also the law that no adjustment for the value of intervening life estates is to be made to the basis as regards the remainderman; he is entitled to the full valuation of the property without regard to the life estate.[35]

Will contests and litigation as to the right of inheritance are not infrequent, and there are two important rules affecting them to be remembered in taking title to real estate as a result of such contests. In the first place, if the property is acquired by inheritance either directly or as the result of litigation deciding the invalidity of a will, the basis is the fair market value at the date of decedent's death and not at the date of the ending of the litigation, if there is any.[36] Secondly, where will contests are settled by the parties, and there is consequently a readjustment of interests acquired under the will but the readjustment is not based on any claim of inheritance, it is held that this new acquisition is by way of contract and not by way of devise so that the basis of the property redistributed is the fair market value as of the date of the settlement contract and not as of the date of the decedent's death.[37]

There is further to be considered the basis to the decedent's estate of property acquired by it from the decedent. In such cases, the Internal Revenue Code provides that the basis is the fair market value on the date of death or one

34 See 3 Mertens, sec. 21.60, n. 4 (1942), and cases there cited.

35 Robert E. McGrath, 30 B.T.A. 562 (1934), aff'd. sub. nom. Fidelity and Columbia Trust Co., Trustee v. Commissioner, 90 F. 2d. 219 (C.C.A., 6th, 1937), cert. den. 302 U.S. 723, 82 L. Ed. 558 (1937). Huggett v. Burnet, 64 F. 2d. 705 (C.A., D.C., 1933).

36 Quigley v. Commissioner, 143 F. 2d. 27 (C.C.A., 7th, 1944).

37 Mertz v. Hickey, 68 F. Supp. 159 (D.C., N.Y., 1946).

year thereafter, whichever is elected, or on the date when the property is sold or distributed, in other words, the usual rule.[38]

The basis to the survivor of joint tenancies or of tenancies by the entireties is of vital importance in Florida, since so much realty is taken in this manner. It is now decided that the basis to the survivor on sale or exchange is the original cost of the property at the time it was acquired by the co-tenants, since a survivor of a joint tenancy or a tenancy by the entireties does not take by devise or inheritance.[39]

As in all basis considerations, it must be stated that property acquired by devise or inheritance is subject to special treatment if it was so acquired prior to March 1, 1913. The Internal Revenue Code provisions are determinative here,[40] and they state that the basis to be used in determining gain is either the fair market value at the date of decedent's death or the fair market value as of March 1, 1913, whichever is the greater. Note that this rule is applicable only to the situation in which there is a gain. If a loss is incurred, it would seem that the fact that the property was acquired prior to March 1, 1913, would be of no consequence and that the loss would be computed in the usual way by using the fair market value as of the date of decedent's death as the basis.[41]

V

The next general question to consider is property acquired by gift. Here, again, the language of the Internal Revenue Code is clear enough. It provides that property acquired by gift after December 31, 1920, has the same basis in the hands of the donee as it had in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for purposes of determining loss the basis shall be either the basis as determined in the above manner or the fair market value of the

38 Int. Rev. Code, sec. 113(a)(5). See Estate of Edwin Hodge, 2 T.C. 643 (1943).

39 Lang v. Commissioner, 289 U.S. 109, 77 L. Ed. 1066 (1933). See Albert B. Bernstein, Tax Dangers in Estates by the Entireties, 1 Miami L.Q. 86, for a thoughtful discussion of this subject.

40 Int. Rev. Code, sec. 113(a)(14).

41 See 3 Mertens, sec. 21.73 (1942).

property at the time of the gift, whichever is the lower.[42] This section of the Internal Revenue Code has been held to be constitutional in the case of Taft vs. Bowers.[43]

It is important to know that the exception stated above with reference to the computation of basis for purposes of loss came into the law in 1934; prior to that time, basis was computed in the same manner whether the result was a gain or a loss.[44]

Suppose the donor himself acquired the property by gift. The Internal Revenue Code would seem to take care of this situation in so far as it states "or the last preceding owner by whom it was not acquired by gift".[45] However, suppose the present donor acquired the property by gift prior to December 31, 1920, when the provisions for basis of property acquired by gift were first put into the law. In these circumstances, it is provided that the basis of property acquired by gift from a donor who himself acquired the property by gift prior to December 31, 1920, is the fair market value of the property at the time of acquisition by the present donee.[46]

There has been a change in the law relative to the basis of property which was the subject matter of a gift in trust. Prior to 1942, it was held that where property was acquired by way of a gift in trust the basis was to be the same as the basis in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer.[47] This was obviously different from the normal treatment afforded gifts. However, section 143(b) of the 1942 amendments to the Internal Revenue Code,[48] and the Reg-

42 Int. Rev. Code, sec. 113(a)(2).

43 278 U.S. 470, 73 L. Ed. 460 (1929).

44 See 3 Mertens, sec. 21.41 (1942).

45 "The basis shall be the same as it would be in the hands of the donor, or the last preceding owner by whom it was not acquired by gift." Int. Rev. Code, sec. 113(a)(2).

46 E.D. Knight, 28 B.T.A. 188 (1933). Int. Rev. Code, sec. 113(a)(4).

47 The cases decided prior to the 1942 amendment to the Internal Revenue Code stated that sec. 113(a)(3) applied to gratuitous transfers in trust rather than sec. 113(a)(2). Title Guarantee and Trust Co., Trustee, 42 B.T.A. 748 (1940), aff'd. 123 F. 2d. 819 (C.C.A., 2d., 1941).

48 Sec. 143(b) of the 1942 Revenue Act amended section 113(a)(3)

ulations[49] issued by the Internal Revenue Department pursuant thereto, have now cleared up all controversy, and all transfers which are gifts, whether in trust or outright, are to be treated in the same fashion, and the rules applicable to gifts generally are equally applicable to gifts in trust.

Where a gift is held to be in contemplation of death and therefore includable in the gross estate of the donor for estate tax purposes upon his death, the basis of the property which is the subject matter of the gift is arrived at in the same manner as is the basis of any other gift.[50] While this seems logical enough, there was dispute about it, and some of the earlier laws provided otherwise.[51]

A gift may have been made so long ago that it is impossible to tell what the basis of the property was in the hands of the donor. In such case, the Internal Revenue Code[52] provides that the Commissioner's determination of the fair market value of the property as of the date or approximate date that the property which is the subject matter of the gift was acquired by the donor shall be final as to the basis of the property in the hands of the present donee.

Property is often acquired through the exercise of a power of appointment. If the power is exercised by will, without consideration, the basis in the hands of the donee of the property is the value of the property at the date of the death of the donee of the power, which is the time

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so as to exclude from its operation a transfer in trust made by way of gift, bequest or devise. This means, of course, that gifts which are transfers in trust are now treated as are all other gifts in the determination of basis, as provided in section 113(a)(2) of the Internal Revenue Code.

49 U.S. Treas. Reg. 111, sec. 29.113(a)(2)-1. U.S. Treas. Reg. 111, sec. 29.113(a)(3)-1.

50 It is now held that Int. Rev. Code, sec. 113(a)(2) is applicable to gifts in contemplation of death as well as to other gifts, and not Int. Rev. Code, sec. 113(a)(3). Helene V.B. Wurlitzer, 29 B.T.A. 658 (1934), aff'd. 81 F. 2d. 928 (C.C.A., 6, 1936). Prior to the 1942 amendment by section 143 of the 1942 Revenue Act, some cases held otherwise. See 3 Mertens, sec. 21.42 (1942).

51 See 3 Mertens, sec. 21.42, n. 29 (1942).

52 See Note 42, supra.

when the power was exercised.[53] However, where the power of appointment is exercised other than by will, without consideration, the basis is the same as it is in all other gifts, and is thus the cost or other proper basis to the donor of the power.[54]

VI

Another exception to the general rule of cost as basis deserves brief consideration. Section 113(a)(9) of the Internal Revenue Code states that property acquired as a result of a compulsory or involuntary conversion shall have the same basis as the property so converted, decreased in the amount of any money received by the taxpayer which is not used for the purpose of replacing the destroyed property and increased by the amount of gain recognized on the conversion. This provision, like other provisions dealing with substituted basis, is an effort to keep the taxpayer whole but not to permit him to make an untaxed profit out of the transaction. Its applicability to real estate is only in terms of the improvements that are upon the land and may be considered only in relation to the basis of the building and not of the land. The rule finds its principal use in questions involving insurance and condemnation award.[55]

VII

A familiar technique for postponing taxes is that provided by Sections 113(a)(6) and 112(b) of the Internal Revenue Code, the tax-free exchange of properties of like kind. Section 112(b) states that an exchange may be treated as tax-free, where property held solely for productive use in trade or business or for investment is exchanged for property of a like kind which is also to be held solely for productive use or for investment. The key words are "investment" and "trade or business". It will serve no purpose here to attempt to give any other definition to these words than the ones normally and usually

53 Int. Rev. Code, sec. 113(a)(5). This is true because the actual transfer took place at death, and thus the property should be subject to the same basis provisions as all other property passing at death.

54 Int. Rev. Code, sec. 113(a)(2). Acquisition in this fashion is exactly like any other gift and should be treated the same way for basis purposes.

55 U.S. Treas. Reg. 111, sec. 29.113(a)(9)-1.

associated with them. To explain, your astute client, A, who is a dentist and not a dealer in real estate at all, owns and holds for investment Blackacre, a parcel of unimproved real estate which he bought in 1927 for $1,000, and which now is worth $25,000. If he exchanges Blackacre for an office building having a fair market value of $25,000 and intends to hold the office building as an investment, the exchange is tax-free when completed, since there has been an exchange of property of a like kind and the new parcel is also being held for investment.[56] In a situation as here described, Section 113(a)(6) of the Internal Revenue Code provides that the basis to A of the office building that he received on the exchange is $1,000, that is to say, the same basis that Blackacre had in his hands. Thus, the office building now has a substituted basis of $1,000, but A has to pay no tax at the time of the exchange. At such time as he sells the office building, he will pay a tax on the difference between the sale price and his basis of $1,000, subject to the capital gain provisions of Section 117 of the Internal Revenue Code.[57]

VIII

One Section of the "tax-free exchange" provisions of the Internal Revenue Code is perhaps more widely known among people who own real estate than the other sections, and that is the section providing for the transfer of property to a corporation controlled by the transferor.[58] Gain or loss on the transfer is not recognized if one or more persons transfer property to a corporation solely in exchange for its stock or securities, and immediately after the exchange the transferor or transferors are in control of the corporation. For example, Mr. Smith owns an apartment house, which cost him $60,000 including land and building, and Mr. Jones owns a hotel, which he pur-

56 U.S. Treas. Reg. 111, 29.113(a) (6)-1, as amended by T.D. 5402, Sept. 5, 1944.

57 The subject of tax-free exchanges between individuals is a large one, and there are many complicated situations beyond the ones here discussed. It is not desired to go further into these situations at this time, but for those readers who are adventurous, see 3 Mertens, sec. 20.16 et seq. for a full treatment of the subject.

58 Int. Rev. Code, sec. 112(b)(5).

chased for $50,000, including land and building. If Mr. Smith and Mr. Jones transfer their respective properties to a corporation in exchange for its stock, there would be no tax to either on the transfer, and the properties will have the same basis in the hands of the corporation that they did in the hands of the individuals. However, this is only true if, immediately after the transfer, Mr. Smith and Mr. Jones together own at least 80% of the total capital stock of the corporation;[59] and further if, immediately after the transfer, the amount of the capital stock received by Mr. Smith is substantially proportionate to the value of his interest in the apartment house prior to the exchange, and the amount of capital stock received by Mr. Jones is substantially in proportion to the value of his interest in the hotel prior to the exchange.

If the apartment house was subject to a mortgage or other liability, these are considered as stock or securities received by Mr. Smith so that in practical effect it is assumed that only the equity in the property is transferred. Assume that the apartment house was subject to a $10,000 first mortgage. If, immediately after the transfer, 1,000 shares of $100 par value stock having been issued, Mr. Smith owned 500 shares and Mr. Jones owned 500 shares, the exchange would still be tax-free.[60]

All transactions that come within the purview of section 112(b)(5) of the Internal Revenue Code are, of course, not so simple as these here discussed. There are many variations on the theme, and the one most frequently encountered is that dealing with "stock or securities".[61] The difficult problem is to decide what is a security.[62] In this paper, it is sufficient to warn the reader to brief thoroughly the question of whether the various kinds of stocks, bonds, or notes that he proposes to have the corporation issue are securities falling within the definition of that word as set out in the Regulations and judicial decisions.

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59 Int. Rev. Code, sec. 112(h).

60 U.S. Treas. Reg. 111, sec. 29.112(b)(5)-2.

61 See Note 58, supra.

62 For a survey of this phase of the subject, see P-H Fed. Tax Serv., paragraph 10254, et seq. (1948).