Forrester A. Clark, 1943, 1 T.C. 660

When a taxpayer receives property in a taxable exchange, the basis of the property received is its cost, which is equal to the fair market value of the property given up in the exchange, even if the initial tax treatment of the exchange was incorrect.

Summary

The Tax Court addressed the issue of determining the basis of bonds received in a taxable exchange, where the initial treatment of the exchange was later determined to be incorrect. The court held that the basis of the bonds should be their cost, which is the fair market value of the stock exchanged for them at the time of the exchange. The court rejected the Commissioner's argument that the bonds should retain the basis of the stock. The court also found that the fair market value of the bonds at the time of receipt was at least $147,976.30, resulting in no taxable gain in the years at issue.

Facts

The taxpayer, Forrester A. Clark, participated in a transaction where stock was exchanged for bonds. The initial tax treatment of this exchange was based on an incorrect understanding of the applicable law. The Commissioner later challenged the basis used for the bonds, arguing it should be the same as the stock's basis. The taxpayer contended that the bonds acquired a new basis equal to their fair market value at the time of the exchange.

Procedural History

The case originated before the Board of Tax Appeals (now the Tax Court) due to a dispute over the proper basis of the bonds. The Commissioner asserted deficiencies, which the taxpayer contested. The Tax Court reviewed the evidence and arguments presented by both parties to determine the correct basis.

Issue(s)

1. Whether the basis of bonds received in a taxable exchange should be the same as the basis of the stock exchanged, or whether the bonds acquire a new basis equal to their fair market value at the time of the exchange.

2. What was the fair market value of the bonds at the time they were received in the exchange?

Holding

1. No, because the bonds acquired a new basis in the taxpayer's hands, equal to their cost, which is the fair market value of the stock exchanged for them.

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2. At least $147,976.30, because the evidence indicated that the bonds were worth at least 75% of their face value at the time of receipt.

Court’s Reasoning

The court reasoned that the general rule under Section 113 of the revenue acts is that basis is cost. The court stated, “Just as the cost of property purchased for cash is the amount of money given for it, so it would seem to follow in a strict sense that the cost of property acquired in an exchange is what the recipient parts with, that is, the value of the property given in exchange.” The court found that properties exchanged for one another can be assumed to be of equal value. Referencing Countway v. Commissioner, the court equated the fair market value of the stock and assets transferred (less cash received) to the fair market value of the bonds at that time. The court determined that the bonds were worth at least $147,976.30 when received, based on the debtor’s financial position, general business conditions, and the terms of the instruments. The court also addressed the Commissioner’s argument that the transaction was a “distribution” or “dividend,” clarifying that even if treated as such, it would be a distribution in liquidation or out of capital, leading to the same result as treating it as an exchange. The court cited McEachern v. Rose, stating that recoupment was not available to the IRS in this case.

Practical Implications

This case clarifies that in a taxable exchange, the basis of property received is its cost, which is the fair market value of the property given up. It emphasizes the importance of determining the fair market value of assets exchanged, even if the initial tax treatment of the transaction was incorrect. This decision is relevant for tax practitioners when advising clients on the tax implications of exchanges and determining the appropriate basis for assets acquired in such transactions. It also limits the IRS’s ability to use equitable recoupment in situations where the statute of limitations has expired for the earlier year.

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