4 T.C. 907 (1945)

The cost basis of stock acquired in exchange for property and an agreement to make future payments is determined by the actual payments made, not the theoretical cost of an annuity contract providing similar payments.

Summary

In 1926, Forrester acquired stock from his father, partially in exchange for agreeing to pay his father and subsequently his mother, a monthly sum for life. The Tax Court addressed how to determine the cost basis of the stock. It held that the cost basis included the actual amount Forrester paid to his parents, not the hypothetical cost of purchasing an annuity to provide similar payments. The court also addressed several other issues including the tax implications of a corporate liquidation, the sale of a debt obligation to Forrester's wife, and the deductibility of certain corporate expenses.

Facts

In 1926, D. Bruce Forrester acquired 150 shares of Forrester Box Co. stock from his father, along with General Box Co. stock. In exchange, Forrester assumed a $36,100.85 debt his father owed to Forrester Box Co. and agreed to pay his father $500 per month for life, then to his mother if she survived him. The Forrester Box Co. liquidated in 1938, and Forrester sought to deduct a loss based on his asserted high cost basis in the stock. The IRS challenged Forrester's calculation of his cost basis, leading to a dispute before the Tax Court.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Forrester's income tax for 1938. Forrester petitioned the Tax Court for a redetermination. The Tax Court addressed multiple issues related to the cost basis of stock acquired and the tax consequences of a corporate liquidation.

Issue(s)

1. What is the cost basis of the Forrester Box Co. stock acquired by Forrester in 1926, considering his assumption of debt and agreement to make monthly payments to his parents?

2. Was the Commissioner correct to reduce Forrester's stock basis by $11,219.50 due to a 1929 distribution?

3. Did Forrester realize income from the sale of his debt to the Forrester Box Co. to his wife?

Holding

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1. The cost basis includes the amount of debt assumed, and the actual payments made to Forrester's parents, not the hypothetical cost of an annuity because the agreement was a contractual arrangement, and the actual payments reflect the bargained-for exchange.

2. Yes, because the parties agree that if the Forrester Co. had a deficit in its accumulated earnings and profits at the time it was liquidated, respondent's action was proper.

3. No, because Forrester's liability was not reduced, and the transaction merely substituted creditors.

Court's Reasoning

The court reasoned that the cost basis of the stock included the debt assumed ($36,100.85) and the actual payments made to Forrester's parents under the agreement. The court rejected using the cost of a hypothetical annuity, emphasizing the actual contractual agreement between Forrester and his father. Citing *Citizens Nat. Bank of Kirksville*, the court emphasized that the arrangement was a bargained-for exchange, not an annuity purchase. The court further found that extending the maturity date of the debt did not alter Forrester's liability to pay at maturity the entire debt. Regarding the sale of the debt to Forrester's wife, the court found that the transaction was a legitimate substitution of creditors, with Mrs. Forrester using her own assets to purchase the debt. The court noted that Forrester did not avoid any liability and, therefore, did not realize income from the transaction. Even assuming Forrester himself was the purchaser, he realized no gain because he purchased the debt at its discounted value. The court did not allow deductions for later payments as they were not made in the tax year. The court emphasized, "Taxpayers are not obliged to so conduct their affairs as to incur or increase their income tax liability, and a transaction may not be disregarded because it resulted from an honest effort to reduce taxes to a minimum."

Practical Implications

Forrester v. Commissioner provides guidance on determining the cost basis of assets acquired in exchange for a combination of property and future payment obligations. The case highlights that the actual costs incurred, rather than theoretical market values, typically govern such calculations. It also reinforces the principle that taxpayers can structure transactions to minimize tax liability, provided the transactions are bona fide and not mere shams. Legal practitioners should consider this case when advising clients on structuring transactions involving future payment obligations and asset acquisitions. Later cases may distinguish Forrester when dealing with related-party transactions that lack economic substance or are primarily motivated by tax avoidance.

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