8 T.C. 376 (1947)

When a taxpayer exchanges a contingent claim against a bank for preferred stock during a recapitalization, the cost basis of the stock for determining gain or loss upon a later sale is its fair market value at the time of the exchange, not the face value of the original claim.

Summary

Mary Kavanaugh Feathers contributed cash to a bank to bolster its financial condition. Later, during a bank recapitalization, her contribution rights were exchanged for preferred stock. When Feathers sold the stock, she claimed a loss based on her original contribution as the cost basis. The Tax Court held that the cost basis of the stock was its fair market value when acquired in the exchange, not the original cash contribution. The court reasoned that the exchange of the contingent claim for stock was a taxable event, and the stock's value at that time determined the basis for future gain or loss calculations.

Facts

The Bank of Waterford faced financial difficulties due to declining bond values. To strengthen the bank, Feathers and other stockholders made cash contributions to secure depositors. These contributions were intended to be returned when the bank's financial condition improved, as determined by the New York State Banking Department. Later, the bank recapitalized, and Feathers exchanged her contribution rights for "B" preferred stock. She then sold the stock and claimed a loss based on her initial cash contribution.

Procedural History

Feathers filed income tax returns claiming a loss on the sale of the bank stock. The Commissioner of Internal Revenue disallowed the claimed losses. Feathers then petitioned the Tax Court, arguing that her cost basis in the stock was her original cash contribution. The Tax Court upheld the Commissioner's determination.

Issue(s)

Whether the cost basis of "B" preferred stock, acquired in exchange for rights to a cash contribution made to a bank to secure depositors, is the fair market value of the stock at the time of the exchange, or the amount of the original cash contribution.

Holding

No, because the exchange of the contingent claim against the bank for shares of stock was a taxable event, and the stock's fair market value at the time of the exchange determines the basis for future gain or loss.

Court’s Reasoning

The court reasoned that Feathers’ contribution to the bank created a contingent claim, not a debt. Her right to a return of the money depended on the bank’s liquidation or the Superintendent of Banks’ determination of sufficient security for depositors. This right was then exchanged for the preferred stock. This exchange was a taxable event, meaning Feathers realized gain or loss at that point. The court rejected Feathers’ argument that she effectively purchased the stock for cash, finding instead that the subscription agreement merely provided a mechanism for applying her contribution towards the stock purchase. The court also determined that the subscription price of $35.50 per share did not reflect the stock’s fair market value, given the bank’s financial condition. The court stated, “The effect of the transaction was an exchange of her rights against the bank, a property right, for shares of its stock.”

Practical Implications

This case clarifies that when a taxpayer exchanges a contingent claim for stock, the transaction is a taxable event. Attorneys should advise clients that the cost basis for determining gain or loss on the subsequent sale of the stock is the stock’s fair market value at the time of the exchange, not the value of the relinquished claim. This principle affects tax planning in corporate restructurings, settlements of claims, and other situations where property is exchanged for stock. This case highlights the importance of valuing assets at the time of exchange to accurately determine the tax consequences. It also demonstrates that a taxpayer’s subjective intent or formalistic subscription agreements will not override the substance of the transaction as an exchange of property.

