9 T.C. 930 (1947)

When a shareholder makes capital contributions or surrenders stock to a corporation to enhance its financial position, the cost basis of the stock sold includes the cost of common stock transferred to another party to procure working capital, plus the portion of the cost of preferred shares surrendered that was not deductible as a loss at the time of surrender.

Summary

William H. Foster, the controlling stockholder of Foster Machine Co., transferred common shares to Greenleaf to secure working capital for the corporation. He also surrendered preferred shares, some of which were canceled and the rest resold to Greenleaf. When Foster later sold his remaining common stock, a dispute arose concerning the basis of the stock for tax purposes. The Tax Court held that Foster's basis included the cost of the common stock transferred to Greenleaf, plus the portion of the cost of the surrendered preferred stock that was not initially deductible as a loss. This decision emphasizes that actions taken to improve a corporation's financial health can impact the basis of a shareholder's stock.

Facts

William H. Foster owned a controlling interest in Foster Machine Co. To improve the company's financial position, Foster entered into agreements with Carl D. Greenleaf. In 1922 Foster agreed to transfer 2,180 shares of common stock to Greenleaf in return for Greenleaf's association with the company as a director and his contribution of working capital to the company. By 1927, Foster transferred 1,050 shares of common stock to Greenleaf. Foster also granted Greenleaf an option to purchase 1,130 shares of common stock which Greenleaf exercised in 1929. In 1935, Foster surrendered 1,848 shares of preferred stock to the company, 1,048 of which were canceled, and 800 were resold to Greenleaf.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in William H. Foster's and L. Mae Foster's income tax for 1940. The estate of William H. Foster petitioned the Tax Court for a redetermination, arguing that there was an overpayment of taxes. The central issue was the correct calculation of the basis of the stock sold in 1940.

Issue(s)

Whether the basis of stock sold in 1940 should include (1) the cost of common stock transferred to an individual to procure working capital for the corporation, and (2) the cost of preferred stock surrendered to the corporation, a portion of which was then resold to that same individual.

Holding

Yes, because a payment by a stockholder to the corporation, made to protect and enhance his existing investment and prevent its loss, is a capital contribution, rather than a deductible loss, and should be added to the basis of his stock.

Court's Reasoning

The Tax Court determined that Foster's actions were aimed at improving the financial standing of Foster Machine Co. rather than generating an immediate profit. The court referenced *First National Bank in Wichita v. Commissioner, 46 Fed. (2d) 283* stating that payments made to protect and enhance a shareholder's existing investment are capital contributions and should be added to the basis of his stock. The court also considered *Commissioner v. Burdick, 59 Fed. (2d) 395*, and *Julius C. Miller, 45 B.T.A. 292*, regarding the surrender of stock. The court determined that Greenleaf was not merely purchasing stock from Foster, but was investing in the business. Therefore, Foster was never in a position to make a contribution of $218,000 to the capital of the corporation. The court found that the cost of the surrendered preferred stock, which was not deductible as a loss, should be included in the basis of the common shares because it enhanced the value of those shares. The court reasoned that the enhancement in the value of the 2,232.5 shares he then owned was $82,513.20. "This part of the cost of the surrendered preferred stock, which was not allowable as a loss deduction because it inured to the benefit of his own common stock, properly becomes a part of the basis of these common shares to be taken into consideration on their final disposition."

Practical Implications

This case clarifies how contributions to a corporation and stock surrenders can affect a shareholder's stock basis for tax purposes. It illustrates that actions taken to improve a corporation's financial health are treated as capital contributions rather than deductible losses. Attorneys and accountants should carefully analyze transactions where shareholders contribute capital or surrender stock, as these actions can have long-term implications for determining capital gains or losses when the stock is eventually sold. This ruling impacts how similar cases should be analyzed, changing legal practice in this area, and has implications for businesses involved in corporate restructuring.

