*27 T.C. 547 (1956)*

When determining the cost basis of assets acquired by a corporation in exchange for its stock, the fair market value of the stock, rather than the price agreed upon in a restricted sale, is the key factor.

**Summary**

The Avco Manufacturing Corporation (Avco) contested the Commissioner of Internal Revenue's determination of deficiencies in income taxes against The Nashville Corporation (Nashville), of which Avco was the transferee. The core dispute centered on the cost basis of assets Nashville received from Consolidated Vultee Aircraft Corporation (Convair) in exchange for Nashville's stock. The Commissioner argued that the cost basis was the price Convair shareholders paid for Nashville's stock, which was determined through a stock purchase agreement. Avco contended that this price did not reflect the fair market value of Nashville's stock because it was not an arm's-length transaction. The Tax Court sided with Avco, holding that the fair market value of the assets transferred by Convair to Nashville determined the fair market value of the stock, and the cost basis should be the fair market value of the assets. The court emphasized that the stock sale was restricted and did not accurately reflect market value.

**Facts**

Convair, controlled by Avco, decided to diversify its business and transferred assets from its Nashville Division to the newly formed Nashville Corporation in exchange for all of Nashville's stock. The transfer was part of an agreement where Convair's shareholders, including Avco, were given the right to purchase Nashville's stock at a set price and Convair would own no shares of Nashville's stock after the transaction. The sale of the stock was restricted to Convair shareholders. The Commissioner determined that the transfer was taxable and that the cost basis of the assets to Nashville was the amount paid by Convair's shareholders for the stock. Avco disputed this valuation.

**Procedural History**

The Commissioner determined tax deficiencies against Nashville. Avco, as transferee, admitted liability for any deficiencies found. The dispute went to the United States Tax Court, focusing on the valuation of the assets transferred and the determination of the cost basis. The Tax Court ruled in favor of the taxpayer, Avco, holding that the agreement of sale did not reflect fair market value. The court would ultimately rule on the remaining issues based on this determination.

**Issue(s)**

1. Whether the sale of assets from Convair to Nashville resulted in a taxable exchange.

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2. Whether the cost basis to Nashville of the assets it acquired from Convair was determined correctly by the Commissioner.

3. Whether the Commissioner's allocation of Nashville's total cost basis among the various classes of assets acquired from Convair was reasonable and proper.

4. Whether Nashville was entitled to net operating loss deductions.

**Holding**

1. The court's decision would ultimately hinge on the determination of the fair market value of Nashville's stock, though the sale was considered taxable by the parties.

2. Yes, the fair market value of the assets, rather than the sale price of stock in the agreement, determined the cost basis of the assets transferred by Convair to Nashville.

3. The court's decision made the determination of this issue moot, as they determined the market value of the stock.

4. The parties conceded that the amount of the net operating losses would be determined by the court's decision on the main issue, which was the determination of the cost basis.

**Court's Reasoning**

The court focused on the determination of the fair market value of Nashville's stock. It acknowledged that, generally, the price in an open-market sale reflects fair market value. However, in this case, the court found the stock sale to be restricted. The court noted that the sale was limited to Convair shareholders, who had to purchase Nashville stock with cash and some of their Convair shares. The court held that such a restricted sale did not reflect the true fair market value. The court then considered the fair market value of the assets, finding that the current assets were worth their book value, given their market value. The court's key legal determination was that when a sale of stock is not at arm's length, the fair market value of the assets received is the best evidence of the fair market value of the stock given in exchange.

**Practical Implications**

This case provides important guidance for determining asset valuations in corporate transfers, especially when stock is not publicly traded. Specifically:

- When there is not an open market for the stock, the fair market value of assets exchanged for stock is used as a basis for determining the fair market value of the stock itself.

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- Restricted stock sales, particularly those not at arm’s length, may not be a reliable indicator of fair market value, especially when a controlling shareholder is part of the transaction.
- This case helps attorneys evaluate the nature of transactions and gather the appropriate information for the valuation of the assets, potentially including market reports and valuations of similar properties.
- Subsequent cases should consider the nature of the stock sale and, if it is restricted, look to the fair market value of the assets involved.

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