FX Systems Corp. v. Commissioner, 79 T. C. 957 (1982)

When stock is exchanged for property, the cost basis of the property is the value of the stock given, not necessarily the fair market value of the property received.

Summary

FX Systems Corp. purchased assets from Ferroxcube Corp. , paying with cash, a promissory note, and preferred stock. The issue was whether the cost basis of the assets should be their fair market value or the value of the consideration given. The Tax Court held that the cost basis was the value of the consideration paid, not the fair market value of the assets, due to the non-arm's-length nature of the transaction and the ascertainable value of the preferred stock.

Facts

FX Systems Corp. was formed to acquire assets of Ferroxcube's Memory Systems Division, which was unprofitable and facing scrapping if unsold. The purchase price included $200,000 cash, a $28,000 promissory note, and 1,000 shares of preferred stock. FX Systems valued the assets at $872,080 based on an appraisal, while the Commissioner valued the preferred stock at its redemption value, leading to a lower cost basis for the assets.

Procedural History

FX Systems Corp. filed a petition in the U. S. Tax Court challenging the Commissioner's determination of deficiencies in its federal income taxes for the years 1973, 1974, and 1975. The case was reassigned following the death of the initially assigned judge and was decided based on stipulated facts.

Issue(s)

1. Whether the cost basis of the assets purchased by FX Systems Corp. from Ferroxcube should be determined by the fair market value of the assets or the value of the consideration given in exchange for the assets?

Holding

1. No, because the transaction was not at arm's length and the preferred stock issued had an ascertainable value; thus, the cost basis should be the value of the consideration given, not the fair market value of the assets.

Court's Reasoning

The court rejected the use of the barter-equation method of valuation, which presumes equal value in an arm's-length transaction, due to the non-arm's-length nature of the deal. Ferroxcube faced the prospect of scrapping its assets if unsold, placing it at a disadvantage in negotiations. The court found the preferred stock had an ascertainable value equal to its redemption price, supported by the lack of evidence from FX Systems to rebut the Commissioner's valuation. The court cited cases like *Pittsburgh Terminal Corp. v. Commissioner* to distinguish the situation and noted the dangers of valuing one side of a transaction by the other side's value when not equal.

Practical Implications

This decision emphasizes the importance of proving arm's-length dealings when using the barter-equation method for valuation. It highlights that the cost basis in transactions involving stock exchanges may be the value of the stock given, not the fair market value of the property received, particularly in non-arm's-length transactions. Practitioners should carefully assess the nature of the transaction and the valuation of any stock involved. This ruling may affect how businesses structure asset purchases involving stock and how they report such transactions for tax purposes. Subsequent cases might reference this decision when determining cost basis in similar situations.

