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Basis for Property Acquired for Stock

By John W. Roberts

In the revenue act of 1924 an attempt was made to stop the leaks by enacting such rules as would prevent those practices whereby many taxpayers were known to be reducing their tax liability. It was brought out that men of wealth were employing experts to search the law, find advantageous technicalities, and devise lawful procedure for so organizing or conducting a business as to subject it to the least possible taxation.

The treasury department had evidently made an exhaustive study of the methods that were in common use. Some of them attained much publicity, such as the investment of funds in state and municipal bonds, and the administration's effort to make such income taxable was carried to the point of proposing an amendment to the constitution of the United States. Many others, however, were taken up quietly, and clauses designed to stop them were recommended to congress and embodied in the new law without attracting much public attention.

Of these clauses one of the most important concerned the avoidance of taxable income by incorporating. The previous revenue acts had provided that no taxable gain resulted when a man or group of men turned in property to a new corporation for its stock. The mere act of incorporating could not produce taxable income. If, later, the corporation sold any of its assets, the taxable gain was determined by comparing the proceeds of the sale with the cost to the corporation, and the cost of assets acquired for stock was taken to be their fair value as capital paid in at the date when they were paid in.

To the average man, this may be very uninteresting, but to men in certain situations it proved to have absorbing interest.

Mr. A. held stocks in numerous companies. They had been acquired over a period of years and some had advanced and others declined as compared with what they had cost. One block of stock in Corporation B had been purchased in 1914 for $100,000, but was now worth $1,700,000. All the other securities taken together had cost him $900,000, and were now worth $800,000. They were all listed stocks and their present value was easily determinable. Mr. A. felt that the time had come when it would be advisable to sell all or part of his holdings in

Corporation B and was particularly anxious to diversify his investments and not risk two-thirds of his estate on one issue. If he sold, however, he would have to report a profit of $1,600,000. Under the 1918 law his income tax would be enormous. Under the 1921 law he could treat this profit as a capital gain and escape with a tax of only $200,000. But even $200,000 is a large sum, and might dissuade him from selling at all.

It was in this situation that he found the above-described clauses of the law very interesting. After studying them, he organized a new corporation known as A, Inc., with an authorized capital stock of $2,500,000. To it he transferred all his stocks, their definitely known market value being $2,500,000, and accepted therefore the stock of A, Inc., with a par value of $2,500,000. By so doing he had not derived any taxable income.

A, Inc., then very properly opened its books by an entry showing $2,500,000 of capital stock issued and by setting up its assets, consisting of stock of Corporation B costing $1,700,000 and other stocks costing $800,000. A, Inc., then sold the stock of Corporation B for $1,700,000, and reinvested the proceeds in other diversified securities. In so doing, the corporation had realized no income. The sale of the large block of stock and the diversification of investments had been accomplished without incurring any liability for income tax either on the part of Mr. A. or on that of A, Inc.

How many times this procedure was utilized, no one can say. But it is common knowledge that private holding corporations have become a usual thing among men of wealth. There are, of course, other great advantages, and many corporations may have been organized for those other purposes. Even in such cases, however, advantage may have been taken later of the increased valuation at which certain assets had been capitalized. It is little wonder that the treasury department sought to close this avenue of avoidance by proposing and securing the enactment of a change in the law. The new clauses of the revenue act of 1924 read as follows:

Section 203 (b) (4)

No gain or loss shall be recognized if property is transferred to a corporation by one or more persons, solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

Section 204 (a) (8)

> If the property (other than stock or securities in a corporation a party to a reorganization) was acquired, after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in paragraph (4) of subdivision (b) of section 203 (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferror, increased in the amount of gain or decreased in the amount of loss recognized to the transferror upon such transfer under the law applicable to the year in which the transfer was made.

The latter clause was evidently suggested by a provision that had already appeared in the revenue act of 1921 which based the computation of income from the sale of gifts on the cost to the preceding owner. But there is a fundamental difference in the situation. A gift really is income to the recipient, and congress doubtless has the right to tax the whole amount of the gift if it wants to do so. It is free also to refrain from exerting its full power, as it has done, and exempt from income tax a portion of an item that really is income. That it did not in the 1921 act exempt the whole, as it had done in previous acts, was a matter entirely within its discretion.

But the above-quoted clauses regarding the basis for corporations are applied to a radically different set of facts. They do not offer an exemption to something that is in its nature income, but attempt to tax as income something which is not income. They were evidently believed both by the treasury department and by congress to be sufficient to stop the leak. But do they? Is the second one valid? Will the courts uphold it?

To revert to our concrete illustration above—Mr. A., personally, is clearly relieved of all taxability upon incorporating, by the terms of section 203 (b) (4). The government can claim the right to tax only the corporation, A, Inc. It will require the corporation to compute its taxable income by comparing the selling price, $1,700,000, with the cost to the preceding owner, $100,000, and report a taxable income of $1,600,000. Can the corporation have a taxable income, if it has no income?

A, Inc., has made no profit. The stock of Corporation B was accepted as capital paid in, and was valued at its actual value as of the date of payment. It constituted $1,700,000 of capital paid in. The sale merely converted the asset into cash. It still represented only capital paid in, and no part of the $1,700,000 represented any profit. And yet the law attempts to assert that

it had realized a taxable net income of $1,600,000. Can congress by legislative fiat make income of that which is not income?

In the revenue act of 1916, congress enacted that a "stock dividend shall be considered income, to the amount of its cash value." But when the matter came to the supreme court, it was decided that *a stock dividend is not income.* That fact controlled, and could not be changed by any declaration of congress. The gist of the decision was that congress can not tax as income, without apportionment, that which is not income.

But, it will be objected, there must be income somewhere in the transactions above described. Whether there is or not, it is clear that A, Inc., has no income, and it is against A, Inc., that the right to tax is claimed. It may be perfectly true that there is income somewhere in New York, but that would be no ground for assessing John Doe, a resident of New York, if he could show that he, personally, had no income.

If there is income somewhere in the transactions, who has derived it? And when? When we study this question we must at once see that unrealized income had accrued through rise in market values over a period of ten years or so, while the stock of Corporation B had been enhancing in value. But it was unrealized. Fluctuations in market value do not affect taxable income as long as the stock is held and not sold. Certainly Mr. A.'s wealth had increased during the ten years, but it was an increase of capital and not income. He had not realized by a closed transaction the increment that had accrued.

This rule may appear unjust to the plain, untutored citizen. And to some degree and in some cases it undoubtedly is unjust. But it is the rule, and must be applied to all alike, including Mr. A. On the whole it is a sound and practical rule. Before the plain, untutored citizen undertakes to change it he must devise some other rule that will be as sound and as practical. At all events, as the law now stands, Mr. A. can not be taxed during those ten years on the increment in his capital due to market quotations.

The first point at which there is any possibility of holding that Mr. A. has derived income is the transaction whereby he exchanges his various stocks for stock of A, Inc. If this occurred in a year governed by the revenue act of 1924, the clear terms of the statute exempt from taxation the income, if any, arising from this transaction. The language of previous acts was not quite

so clear, but we find in article 1563 of regulations 45 the treasury department's interpretation of the revenue act of 1918 expressed in these words:

> " . . . , or if he exchanges his stock for stock in a small closely held corporation, no income is realized if the new stock has no market value, although the conversion is more than formal."

A, Inc., is certainly a "closely held corporation." Whether it is "small" or not depends on what other corporations we compare with it. It would appear that the comparison contemplated is with the large, diffusely held corporations whose stocks enjoy a free market. And this again throws light on the words "market value." There is no market for the stock of A, Inc. It may have a cash value, or a fair value, but does not, as far as I can see, have a market value. So even under the 1918 act the mere fact of incorporating does not entail the realizing of income.

This rule is sound, and based on sound theory. To derive income by the act of incorporating would be like lifting oneself by his boot straps. Income can not be derived from one's acts alone. It must be derived from others. One can not make profits by trading with himself. After merely incorporating, Mr. A. could not have felt justified in buying a house that he could not afford before. His assets were not even more liquid than they were before. The several certificates of stock, which he had owned, had been exchanged for certificates representing an equitable ownership under certain conditions and restrictions in the same property; and the new certificates were less salable than the old.

As mentioned above, the law does not attempt to assert that Mr. A. derived income by the act of incorporating. Even if it did, such an assertion could only await the same fate at the hands of the supreme court as befell the clause that taxed stock dividends, because the act of incorporation does not produce or realize income, but, like stock dividends, merely records devoting to permanent capital use an increment in capital that might otherwise eventually be devoted to personal expenses.

Did Mr. A. personally derive income when A, Inc., sold the stock of Corporation B? No. Before the sale Mr. A. held the stock of a corporation whose assets were worth $2,500,000. After the sale he held the same stock in the same corporation whose assets had the same value. As far as this transaction is concerned Mr. A. personally has bought nothing, sold nothing,

paid nothing, received nothing. He has not even experienced any accrued increment in capital. By no stretch of the imagination can it be said that he personally derives income from the sale of stock of Corporation B by A, Inc. He does not even derive a right as a director of A, Inc., to declare a dividend, for the corporation has no profit out of which a dividend can be declared.

Where, then, does the income lie? It lies simply and solely in the ten years or so during which the value of the stock of Corporation B was increasing. It was an unrealized increment of capital. And neither the incorporation nor the subsequent transactions of the corporation resulted in realizing the profit as income. The government in most cases is not in any way deprived of taxes by the careful study that such men give to the law. If Mr. A. had not examined the constitutionality of the clause, but had accepted its words at their face value, he probably would have let things remain in statu quo, by simply retaining his personal ownership of the stock of Corporation B, and the government would have collected no tax.

The underlying considerations in this matter are very similar to those in the stock-dividend case. In both cases the law distinctly calls for the inclusion in income of something which is not income. In both cases there has been a gradual accrual of capital increment over a period of years. In both cases the specific transactions alleged to have produced income are in the nature of a permanent dedication to capital of an increment which otherwise might have been devoted to income.

In one point only does the analogy fail, and that is that whereas the stock dividend was asserted to be income against a person who had enjoyed the benefit of a capital increment, the alleged profit on the sale of the stock of Corporation B is asserted to be income of a person who had no profit and no capital increment.

In deciding a rule of law the court must consider how the rule would work in cases other than the one specifically before it. In the stock dividend case the supreme court did not fail to note the evident injustice that would be done to the man who buys stock just before the stock dividend is declared and really, in the high price of the stock, pays for the new shares as well as the old. The court took cognizance of the fact that not every recipient of a stock dividend has held the stock during the entire period while the profits of the corporation were accumulating. So, here, it

must take cognizance of the fact that not every man who organizes a new corporation retains its stock until the corpration has sold the assets that he transferred to it.

Mr. C. who was in a similar position to Mr. A. incorporated with somewhat different purposes in view. His corporation did not at once sell any of its assets, but he sold all the stock of Corporation C to Mr. D. for $2,500,000. (We are assuming the same set of figures.) Having done this Mr. C. reported an income from the sale of stock of Corporation C of $1,500,000 and paid a heavy personal tax. Eventually Mr. D., now in control of Corporation C, causes it to sell its holdings of Corporation B. Section 204 (a) (8) would then require Corporation C also to report an income which would be computed as $1,600,000 and taxed $200,000.

This tax of $200,000 comes as a surprise to Mr. D. Is there any justice or any useful purpose in thus surprising him? Mr. D. had carefully studied the assets of the company he was buying. He had assured himself that the assets were worth all that the books represented them to be, and that there were no liabilities and no accrued taxes. He had done all that a cautious buyer could be expected to do, and at the time of the purchase it was true that no income-tax liability existed. The injustice to Mr. D. is so evident that it needs no more discussion.

But here we have been dealing with a special type of corporation. Let us see how the application of section 204 (a) (8) would affect the great mass of business corporations. Most corporations are started by some transaction whereby stock is issued for certain specified assets turned in, sometimes a going business, sometimes a patent, sometimes a mining claim.

Mr. E. at trifling expense secures a patent which has great value. He organizes Corporation F and transfers the patent to it for $800,000. To secure working capital he asks Mr. G. and Mr. H. each to take $100,000 of the stock at par. Having investigated the proposition and satisfied themselves that the patent, valued at $800,000, pays for Mr. E's stock as fully as their cash pays for their own, they accept the proposition, and pay in $200,000 of cash. Before operations are really commenced a large and powerful corporation becomes interested and offers $800,000 for the patent. Mr. E. regards a bird in the hand as worth two in the bush, and, being in control of Corporation F, he causes it to sell for $800,000. He figures that there will then be

$1,000,000 of cash in the bank account of Corporation F which can be paid back to the stockholders refunding their investment and cancelling the stock.

At this point it is discovered that Corporation F has taxable income of $800,000 and a liability of $100,000 for income tax, and only $900,000 of free cash with which to redeem $1,000,000 of stock. Mr. G. and Mr. H. eventually receive on dissolution their shares of the corporation's assets or $90,000 each. Mr. E. on dissolution receives $720,000 which he is required to return as income. Can anyone justify this double taxation of income, and the losses thus inflicted on Mr. G. and Mr. H. by the operation of this clause of the law?

It may be objected that corporations do not usually sell their capital assets, and that therefore cases like the above are comparatively rare. I admit that most corporations retain their capital assets, or dispose of them through reorganizations for which special provision is made in the law. But the clause in question concerns only those corporations that do sell their capital assets and in nearly every imaginable case in which it applies it works injustice.

The only case where it does not work palpable injustice is where the man who paid in property for stock is the sole stockholder and retains his stock until all the assets in question have been sold and the tax determined. But there is nothing in the clause that would limit its operation to those unusual circumstances. And even in the case where its injustice is not palpably evident, it results in ultimate duplicate taxation of income, because a profit will again be asserted when the sole stockholder sells his stock.

It is to be hoped that, when congress reassembles and takes up another revision of the revenue act, this clause will be reviewed and eliminated, both on the ground that it is probably unconstitutional and void, and on the ground that, even if valid, it introduces needless intricacies and complications and fails to accomplish justice.