Winter 1989

Realization and Recognition of Losses on Stock Surrenders: A Frolic Through Subchapter C

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REALIZATION AND RECOGNITION OF LOSSES ON
STOCK SURRENDERS: A FROLIC THROUGH
SUBCHAPTER C

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A shareholder's surrender of stock to a corporation for no consideration arguably results in a realized loss to the shareholder. But should that loss be recognized? The Supreme Court's decision in Fink v. Commissioner denied loss recognition for stock surrenders resulting in only a small reduction in a shareholder's percentage ownership in a corporation. While correct in result, the analytical basis for this decision is problematic and offers a unique opportunity to examine the basic issues of loss realization and recognition within the context of subchapter C of the Internal Revenue Code.

STOCK surrenders, in which shareholders surrender all or a portion of their stock to the corporation for no consideration, occur for a variety of reasons, but primarily in connection with the recapitalization of a troubled company. Often, in a formal or informal recapitalization, shareholders will surrender their stock in order to strengthen the financial picture of the corporation, to induce outside persons to invest in the corporation, or to allow a key employee to acquire stock in the corporation.

After the stock surrender, the surrendering shareholder owns fewer shares in the corporation, and if there is more than one shareholder, a reduced percentage of stock ownership in that corporation. Because no consideration is received for the shares, the surrendering shareholder may claim that the surrender produces a loss in the amount of the shareholder's basis in the stock surrendered. This loss would presumably qualify as an ordinary loss under section 165(c)(3) of the Internal Revenue Code, since the shareholder did not "sell or exchange" the shares. The creation of an ordinary loss under circumstances seemingly within the control of the shareholder is of concern to the Internal Revenue Service, and also raises fundamental theoreti-

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1. All section references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

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cal questions about the realization and recognition of losses in a sound tax system.

These questions were ultimately presented to the Supreme Court in *Commissioner v. Fink*, after becoming the subject of three divergent appellate decisions. Part I of this Article examines these cases and their Tax Court antecedents. Because stock surrenders share some of the characteristics of a variety of other, more familiar, transactions between shareholders and their corporations, it has been deceptively easy for the courts to use these transactions as templates for determining the appropriate tax consequences for stock surrenders. For example, in certain ways stock surrenders resemble capital contributions, sales of stock, capital expenditures and even stock dividends. However, the resemblance between a stock surrender and any of these other transactions is far from perfect. Therefore, relying on statutes and the body of case law that evolved in dealing with these other transactions ultimately leads to confusion in the stock surrender context.

A more useful approach is to analyze loss recognition in the stock surrender context just like any other loss recognition question. First, has the surrendering shareholder realized a loss? If not, the inquiry ends with no loss deduction. As explained below, stock surrenders seem to result in realized losses. The second step is more complex. If the taxpayer realizes a loss on surrender, does the Code allow recognition of that loss? Although section 165(a) would seem to allow a deduction for all realized losses, other Code sections may preclude or defer recognition. Analysis of these sections determines the statutory answer to the deductibility question. Part II of this Article examines these issues, and concludes that the Code does not preclude recognition of losses realized in stock surrenders.

Even if the Code does not preclude recognition of stock surrender losses, the question remains: Should stock surrender losses be deductible as a matter of policy? The proper allowance of capital recovery is crucial to the accurate measurement of the taxpayer's income from the corporate investment. On the other hand, premature allowance for capital recovery can undermine the double tax system imposed by subchapter C. Part III examines how subchapter C resolves these competing concerns in a variety of contexts and concludes that for stock

surrenders, the need to protect the integrity of the double tax structure greatly overshadows the income measurement problem, and thus, denial of loss is appropriate.

I. FROM SCOVILLE TO FINK

The issue of deductibility of losses on stock surrenders is not a new one to the courts. Although the Tax Court allowed such losses in early cases, the enactment of I.R.C. § 83 apparently precluded these deductions, at least for compensation related transfers. A trilogy of recent cases brought the issue before the appellate courts, and ultimately before the Supreme Court in Commissioner v. Fink.

A. Losses Allowed by the Tax Court

A cluster of cases arising in the 1920s brought the stock surrender problem to the attention of the courts. The "easy case" arose first: When all the shareholders of a corporation surrender stock pro rata, receiving in return no consideration, have they realized a loss on the transaction? Presented with this situation in Scoville v. Commissioner, the Tax Court found "no more loss than there is a gain in a stock dividend." In the type of stock dividend to which the court was referring, each shareholder receives additional shares but maintains the same percentage interest in the corporation. After the pro rata surrender in Scoville, each shareholder had fewer shares but the same percentage interest in the corporation. In this situation, according to the court, the remaining stock of the shareholders absorbed the value inherent in the surrendered stock, and thus, no loss occurred.

A slightly more difficult case arose in Wright v. Commissioner, in which a pro rata stock surrender occurred as an integral part of a

6. The cases described in this section have been discussed extensively. See August & Levine, Sup. Ct. in Fink Holds Non-Pro Rata Stock Surrenders are Capital Contributions, 67 J. TAX’N 130 (1987); Bolding, Non-Pro Rata Stock Surrenders: Capital Contribution, Capital Loss or Ordinary Loss?, 32 TAX LAW. 275 (1979); Dickens, Is the Fink Decision Really What It Appears to Be?, 14 J. CORP. TAX’N 55 (1987); Gebhardt, Where are Loss Deductions Available on the Voluntary Surrender of Stock?, 43 J. TAX’N 22 (1975); Johnson, Tax Models for Nonprorata Shareholder Contributions, 3 VA. TAX REV. 81 (1983); Keller, Frantz v. Commissioner: Non Pro Rata Surrender of Stock to the Issuing Corporation, 38 TAX LAW. 739 (1985).
7. 18 B.T.A. 261 (1929).
8. Id. at 264 (citing Eisner v. Macomber, 252 U.S. 189 (1920)).
9. Id. at 264-65.
10. 18 B.T.A. 471 (1929), aff’d, 47 F.2d 871 (7th Cir. 1931).
transaction designed by a troubled corporation's bank to transfer majority ownership of the corporation to new managers selected by the bank. The court observed that under the Scoville rationale, if the pro rata stock surrender had occurred alone, no loss would have resulted. However, the effect of the entire transaction was a change in the respective ownership interests of the corporation, which led to the realization of a loss by the surrendering shareholders. In a prescient dissent, Judge Murdock questioned whether a shareholder taking steps to avoid a loss could ever actually incur a loss. According to this dissent, a surrendering shareholder forged a bond between the surrendered shares and the retained shares that could not be broken. As a result, the transaction should remain open until the shareholder disposed of all of his shares; the loss (if any) could not be determined until disposal of the entire investment. Judge Murdock's dissenting opinion, however, was ignored in subsequent cases. Taxpayers were allowed losses when shares were surrendered to the corporation for transfer to others and for cancellation by the corporation. In these cases, the courts viewed the shareholder's investment in the corporation as divisible into share units; disposition of any unit resulted in a loss to the shareholder due to the change in the shareholder's percentage interest in the corporation. This loss equalled the shareholder's investment in the surrendered shares less the amount of benefit to the shareholder's remaining shares. The character of the loss depended upon the facts. If a sale or exchange had occurred, the loss would be capital in nature, while in the absence of a sale or exchange, an ordinary loss would be allowed.

One case in particular warrants attention. In Foster v. Commissioner, the taxpayer transferred half of his common shares in his

11. Id. at 472.
12. Id. at 473.
13. Id.
14. Id. at 473-74 (Murdock, J., dissenting).
17. See Downer, 48 T.C. at 91.
18. E.g., Duell v. Commissioner, 19 T.C.M. (CCH) 1381 (1960); Budd Int'l Corp., 45 B.T.A. 737; see also O'Brien, Stock Transfers by Shareholders to Outsiders for Nontangible Consideration, 39 Taxes 675, 675-83 (1961).
troubled corporation to a new investor and surrendered some 1,800 preferred shares to the company. He subsequently sold his remaining shares, and the question arose as to the proper computation of the gain on the sale: Did the basis of the shares include all or any part of the basis of the surrendered shares? The Tax Court concluded that only the disallowed portion of the loss on surrender, attributable to the amount of benefit to the remaining shares, should have been added to the basis of the remaining shares. Thus, the court implicitly approved the result in previous cases of allowing the taxpayer a loss for the difference between the cost of the surrendered shares and the benefit to the remaining shares.

B. Tilford v. Commissioner

The first inkling of a change in perspective came in *Tilford v. Commissioner*. Tilford involved a situation common in the earlier cases, a transfer of stock to an employee, but occurred after the enactment of I.R.C. § 83. In this case, the taxpayer owned all of the stock of a financially troubled corporation. He sought to motivate the corporation's employees by "selling" them blocks of his own stock at $1.00 per block and, as a result, claimed capital loss deductions in the amount of the difference between his basis in the shares and the "sales price." The Service disallowed the losses, asserting that they were contributions to the capital of the corporation and constituted transfers of property in connection with the performance of services under section 83 of the Code. The Tax Court ruled in favor of the taxpayer and held that the regulation on which the Service relied was invalid.

On appeal, the Sixth Circuit reversed, finding the regulation, which disallowed the loss claimed by the taxpayer, consistent with the legislative history of I.R.C. § 83. Accordingly, the basis of the shares was considered a contribution to capital. Therefore, at least in the context of compensation related transfers, the deductibility of stock surrenders and transfers was called into question. Whether this holding was applicable in the traditional arena of stock surrenders, i.e.,

20. *Id.* at 937.
21. *Id.*
23. *Id.*
27. *Id.* at 830.
28. *Id.*
the transfer of stock to strengthen the financial condition of a troubled corporation, remained for further consideration by the circuit courts.

C. Schleppy, Frantz and Fink

Three recent court decisions revived the issue of deductibility of losses on stock surrenders. In each of these cases, a shareholder of a closely held corporation transferred stock to the corporation in an apparent attempt to bolster the capital of the business. Faced with the issue of the deductibility of the losses on surrender, the appellate courts disagreed on the proper analysis to be applied to stock surrenders and on whether the loss should be deductible. The Supreme Court resolved the issue in Commissioner v. Fink.29

1. Schleppy v. Commissioner30

In Schleppy v. Commissioner, two taxpayers (referred to here as the taxpayer) were officers, directors, and shareholders of a Georgia corporation (C & S) in which they owned, collectively, 810,500 of 1,155,833 shares outstanding, or 70.12% of the stock. The remaining 29.88% of the stock was held by the public and a creditor of the corporation. The corporation had issued $1,000,000 in debentures, convertible into C & S stock at $7.00 per share, to Shareholders Associates, Inc. (Associates). Associates threatened to call the notes, which would have placed C & S in bankruptcy, unless the convertibility ratio of the notes was changed to $5.00 per share.31 The taxpayer’s counsel determined that a remote possibility existed that the minority public shareholders of C & S could sue for mismanagement resulting from dilution of shares, should the notes be converted at the new rate.32 The taxpayer’s surrender of sufficient shares to the company to prevent dilution would avert this possibility. Such a surrender would leave the taxpayer with 68.57% of the total outstanding stock of the company. The Tax Court found, however, that the possibility of a successful suit was so remote as to not be the dominant reason for the transfer. Rather, the court found that the reason for the surrender was that the company did not have sufficient stock to meet the new

30. 601 F.2d 196 (5th Cir. 1979), rev’g Smith v. Commissioner, 66 T.C. 622 (1976).
31. Id. at 196-97.
conversion ratio without additional issuance of stock, and the conversion ratio change was necessary to keeping C & S in business.\textsuperscript{33}

The taxpayer considered the stock surrender a realization event resulting in recognition of an ordinary loss under section 165 of the Code in the amount of the fair market value of the stock.\textsuperscript{34} The Service disagreed, taking the position that no realization event had occurred, but rather that the taxpayer had merely made a contribution to capital of the corporation. Thus, as in any contribution to capital, the basis of the surrendered stock was to be added to the taxpayer's basis in his remaining shares.

The Tax Court followed the line of cases discussed above, holding for the taxpayer. On appeal, however, the Fifth Circuit reversed.\textsuperscript{35} Suggesting that the Tax Court's reliance on \textit{Foster v. Commissioner}\textsuperscript{36} and \textit{Downer v. Commissioner}\textsuperscript{37} was misplaced,\textsuperscript{38} the court concluded that no realization event had occurred. Presumably because of an incomplete record, the court found that it was impossible to determine when the transaction occurred, and thus, whether the taxpayers actually incurred a loss.\textsuperscript{39} More importantly, the court foreshadowed the crucial issue of the \textit{Fink} and \textit{Frantz} decisions by suggesting that the taxpayer enjoyed substantially the same position as a shareholder both before and after the surrender: a less than two percent\textsuperscript{40} reduction would simply not be significant enough to be considered a loss.\textsuperscript{41} A fundamental concern of the court was whether a loss had occurred at all. In this particular case, the taxpayer's remaining shares presumably benefitted from the surrender by some amount; the benefit was either the taxpayer's post-surrender interest (68.57\%) in the book value of the shares or the ultimate value of the surrendered shares to the corporation (the amount of debt satisfied if the shares were converted under the creditor's option, or the amount realized on sale of the shares to some other party at the existing book value of the company).\textsuperscript{42} Because it was impossible to determine the ultimate effect of

\begin{itemize}
\item \textsuperscript{33} \textit{Id.} at 642.
\item \textsuperscript{34} On his return the taxpayer had reported both a long-term capital gain in the amount of the difference between the value of the stock surrendered and its basis, and ordinary loss in the amount of the value of the stock. \textit{Id.} at 641.
\item \textsuperscript{35} Schleppy v. Commissioner, 601 F.2d 196, 196-99 (5th Cir. 1979).
\item \textsuperscript{36} 9 T.C. 930 (1947), \textit{acq.} 1948-1 C.B. 2.
\item \textsuperscript{37} 48 T.C. 86 (1967).
\item \textsuperscript{38} Schleppy, 601 F.2d at 198.
\item \textsuperscript{39} \textit{Id}.
\item \textsuperscript{40} The actual reduction was only 1.55\%. \textit{Id}.
\item \textsuperscript{41} Whether a de minimis rule exists in the realization arena is subject to some debate. See \textit{infra} notes 120-21 and accompanying text.
\item \textsuperscript{42} The issue of whether treasury stock is of value to the corporation, and if so, of what
\end{itemize}
the surrender, adding the basis of the surrendered shares to the basis of the taxpayers' remaining shares would keep the transaction open until this result could be known.\textsuperscript{43}

Thus, according to the Fifth Circuit, ordinary loss treatment was inappropriate. Presumably, the case did not preclude the allowance of a loss in a situation fundamentally different from the facts of \textit{Schleppy}, in which, for example, the taxpayer's interest in the corporation was significantly reduced.\textsuperscript{44}

2. Frantz v. Commissioner\textsuperscript{45}

In 1971, a taxpayer acquired 13\% of the outstanding convertible preferred stock of a troubled perfume company, Andree Baillot, Ltd. (ABL), as part of the corporation's reorganization and agreement with creditors. Subsequently he purchased 65\% of the outstanding common stock as well.\textsuperscript{46} The reorganization, however, did not result in the desired effect. All of the inventory and accounts receivable were pledged to creditors, the landlord was threatening eviction and additional funding was desperately needed. Counsel to ABL advised the preferred shareholders to contribute their stock to the company to make the corporation more attractive to outside investors. Only the taxpayer agreed to do so, contributing to the company preferred stock with a basis of $32,000. He reported a $32,000 ordinary loss for federal income tax purposes, but the Service objected, claiming that the transaction was merely a contribution to capital.\textsuperscript{47}

The Tax Court noted both the taxpayer's reliance on its previous decisions\textsuperscript{48} and the recent appellate disapproval of those decisions in \textit{Schleppy v. Commissioner}. "[T]he time has come," the court stated, "to reassess our position and to confess error if necessary."\textsuperscript{49} The court reversed its prior decisions by holding that the taxpayer had made a contribution to capital, much as if he had contributed cash or notes. First, the Tax Court explained the "fragmentary" view of value, is problematic. In \textit{Schleppy}, peculiar facts existed giving the treasury shares significant, though contingent, value: the option price at which the creditor could convert the $1,000,000 debt. In the absence of such facts, whether the value of treasury shares could be established, much less allocated to the remaining shares of the surrendering shareholders, is questionable. \textit{Schleppy}, 601 F.2d at 198-99.

\begin{footnotes}
\textsuperscript{43} Id. at 199.
\textsuperscript{44} Id. at 198-99.
\textsuperscript{46} Id. at 164-66.
\textsuperscript{47} Id. at 168-70.
\textsuperscript{48} See supra notes 7-21 and accompanying text.
\textsuperscript{49} Frantz, 83 T.C. at 174.
\end{footnotes}
stock ownership. Under the fragmentary view, each share is a divisible and independent investment in the corporation; thus, disposition of a share "closes" the transaction and requires a determination of the tax consequences of the disposition of that share. On the other hand, under the "unitary" view, the shareholder’s entire investment in the corporation is viewed as a whole. Accordingly, only upon disposition of that entire investment can it be determined whether gain or loss has been realized.50 Because the intent of the taxpayer in a surrender transaction is to prevent or minimize a loss on his remaining investment in other shares, the connection between the surrendered shares and the retained shares justifies leaving the transaction open by adding the basis in the surrendered shares to the basis in the shares retained.51

On appeal, the Second Circuit affirmed.52 The court contrasted the sale of shares by a taxpayer to a third party, in which the transaction is clearly closed, with a surrender of stock, in which the transaction’s essential character is more ambiguous. It appeared to the court that because the taxpayer’s motive is to protect the value of his remaining investment in the company, the surrender represents, paradoxically, a continuation of his investment in the company.53 The court found such a situation analogous to a payment made to further an ongoing investment, which is not deductible as a loss but rather is a capital expenditure increasing the taxpayer’s basis in the investment.54 The same rationale would apply to a contribution of cash or other property to a corporation by a shareholder,55 and should apply to the contribution of shares.

The Second Circuit echoed the Schleppy court’s concerns in questioning whether the surrendering shareholder suffered any loss at all. The reduction of his interest in the corporation by only a "minuscule amount" hardly justified a capital loss, much less an ordinary one.56 The court, however, specifically limited its holding to the situation of a minor change in shareholdings and implied that when the change in net equity was more significant, loss treatment might be found.57

50. Id. at 180 (citing Downer v. Commissioner, 48 T.C. 86, 95-96 (1967) (Drennan, J., dissenting)).
51. Id. at 180-81.
53. Id. at 125.
55. Perlman v. Commissioner, 252 F.2d 890 (2d Cir. 1958) (contribution of cash in the form of cancellation of accrued but unpaid salary); Treas. Reg. § 1.61-12(a) (1980) (shareholder cancellation of indebtedness).
56. Frantz, 784 F.2d at 125.
57. Id. at 126.
The Second Circuit also noted the "practical and jurisprudential" problems of both the fragmentary and the unitary approaches. From a practical standpoint, adoption of the unitary view might inhibit stock transfers designed to improve the financial condition of ailing companies and, thus, force them into bankruptcy. On the other hand, adoption of the fragmentary view could enhance the desirability of a stock surrender because capital losses could be converted to a more beneficial ordinary loss under the fragmentary approach. Thus, rather than selling the shares or waiting for the stock to become worthless, either of which would result in a capital loss, the shareholder could surrender the shares and obtain an ordinary loss. Giving controlling stockholders an option to convert capital losses into ordinary losses at will simply did not appeal to the court.

3. Fink v. Commissioner, The Sixth Circuit's Approach

With two circuit courts agreeing in Frantz and Schleppy on the proper tax treatment of stock surrenders, the issue might have been laid to rest. However, the taxpayer in Fink v. Commissioner claimed an ordinary loss in circumstances similar to those of Frantz.

The taxpayer in Fink v. Commissioner was the principal stockholder in Travco Corporation, a Michigan corporation engaged in the manufacture and sale of motor homes, recreational vehicles, and their component parts. Travco prospered until the energy crisis of 1973 and 1974, which caused a decline in the market for Travco products. At the time of the crisis, Travco enjoyed a line of credit with its bank of approximately $3.4 million. When the bank became concerned with the financial condition of Travco and threatened to call the loan, Travco sought a new lender. A new bank offered attractive financing, but required an infusion of new capital ($700,000 of equity and $200,000 of subordinated debt) as a condition of the financing.

Travco had 1,536,146 shares outstanding of which the taxpayers, Fink and his wife, owned 1,113,659, or 72.5%. The investment bankers handling the recapitalization felt that new capital could more easily be attracted by offering control of the corporation to a new investor. In order to do so, counsel advised the Finks to surrender 196,646 shares of stock to reduce the outstanding shares below 1.4

58. Id. at 124.
59. Id.
60. Id. at 125.
62. Id. at 789.
million. This would allow a new investor to acquire control of Travco by investing $700,000 in new $1.00 par value preferred stock convertible into 1.4 million shares of Travco common stock.63

Fink and his wife surrendered 116,146 shares of common stock in 1976 and 80,000 shares of common stock in 1977. The surrender reduced their ownership interest in the corporation from 72.5% to 68.5%. They reported an ordinary loss on their tax returns for those years in the amount of the basis on the shares surrendered. The Service objected on the now familiar theory that the surrender represented a contribution to capital rather than a realization event resulting in a recognizable loss.64

The Service prevailed in the Tax Court, based upon the appellate decisions in Tilford, Schleppy and Frantz.65 The surprise came when the Sixth Circuit reversed the Tax Court and allowed the Finks' ordinary loss to the extent that the basis in the shares exceeded the incremental benefit to the remaining shares.66 After limiting its own decision in Tilford to the specific legislative arena of I.R.C. § 83, the court examined the Schleppy and Frantz decisions. The result in these cases could only be correct, according to the court, if the unitary view of stock ownership were adopted. But the fragmentary view, requiring allocation of basis and recognition of gain or loss as a share by share determination, was "firmly rooted in the tax law and in this court's decisions" and the facts surrounding this surrender did not justify a departure from that rule.67 According to the court, each share of stock represented a variety of rights, including the right to corporate earnings and assets as well as the right to vote on matters of corporate management. When the taxpayer disposed of the share, whether by sale or surrender, these rights were irretrievably lost, and could not be preserved by simply adding the basis of the surrendered shares to the shareholder's remaining shares. The court observed that the Schleppy and Frantz courts' willingness to allow a loss when the shift in shareholdings was significant68 illustrated their implicit acknowledgement that a loss of some nature had occurred. Thus, the application of a judicial "de minimis" rule disallowing recognition of a "small" loss did not eliminate the loss.69

63. Id. at 788-89.
64. Id. at 789-90.
66. Id. at 433.
67. Id. at 431.
68. See supra notes 38-44 and accompanying text.
69. Fink, 789 F.2d at 432.
The court addressed the capital contribution theory by comparing the effect at the corporate level of a capital contribution of money and of stock. A contribution of money increases corporate capital, but leaves the shareholder's proportionate interest in corporate capital unchanged. Thus, the additional contribution represents an additional price paid for the stock. A non pro rata contribution of stock has a quite different effect in that corporate capital is not increased, and the surrendering shareholder's interest in corporate capital is decreased.\footnote{70} According to the Sixth Circuit, because a contribution of stock in no way resembles a contribution of property, the tax consequences of a capital contribution should not govern recognition in a stock contribution situation.

The court acknowledged the possible practical problems, suggested by the Frantz court, of allowing shareholders the option of converting capital into ordinary losses through stock surrenders. However, the judicial doctrines of business purpose, substance over form, and sham transactions should be sufficient, according to the court, to prevent such abuses.\footnote{71}

In his dissenting opinion, Judge Joiner\footnote{72} objected to the majority's distinction between the transfer of stock to a third party for services in Tilford and the transfer of stock to the corporation. In his view, because the transactions were essentially similar, their tax treatment should be identical.\footnote{73} According to the dissent, the fragmented view was inappropriate in the case where the motivation for the transfer was to benefit the remaining shares because the "expenditure" is capital in nature and should be considered a capital contribution,\footnote{74} particularly if the decrease in shareholdings was so minute as to be illusory.\footnote{75}

\textbf{D. The Supreme Court Decision: Commissioner v. Fink}\footnote{76}

The conflicts among the circuit courts set the stage for the Supreme Court decision in \textit{Commissioner v. Fink}. In the majority opinion, Justice Powell first focused on the rule that no immediate tax consequences arise from a voluntary contribution to capital,\footnote{77} which applies

\footnote{70. \textit{Id.} at 433.}
\footnote{71. \textit{Id.} at 432.}
\footnote{72. \textit{Id.} at 433 (Joiner, J., dissenting). Judge Joiner was a senior district court judge sitting by designation on this case.}
\footnote{73. \textit{Id.} at 434-35.}
\footnote{74. \textit{Id.} at 435.}
\footnote{75. \textit{Id.}}
\footnote{76. 483 U.S. 89 (1987).}
\footnote{77. \textit{Id.} at 94. Presumably the Court meant that this is not a recognition event, resulting in a potential tax, although other tax consequences such as a change in basis do occur.}
not only to transfers of cash or tangible property, but also to a shareholder's forgiveness of a corporate debt.\textsuperscript{78} This rule reflects the general principle that a shareholder may not claim an immediate loss for outlays made for the benefit of the corporation.\textsuperscript{79} Indeed, when a shareholder makes a capital contribution of loss of property to the corporation, no loss is incurred since the value formerly represented by the property transferred is transformed into value of the shares held by the shareholder. The question presented, according to the majority, was whether this principle should also apply to a surrender of a portion of a controlling shareholder's stock.\textsuperscript{80}

In answering this question, Justice Powell first likened the stock surrender to an indirect contribution to capital. When a shareholder forgives a corporate debt, the shareholder is treated as having made a contribution to capital.\textsuperscript{81} Even though a loss is sustained, in the sense that principal, interest and potential voting power in the event of bankruptcy are lost, such losses are not currently deductible. Rather, incurring an expense for the benefit of the corporation is treated as a contribution to the corporation, and gives rise to no immediate tax consequences.\textsuperscript{82}

The majority opinion found the dissimilarities between capital contributions and stock surrenders unimportant. Although financial accounting does not treat a stock surrender as a contribution to capital on the balance sheet of the corporation, the proper financial accounting treatment was not found to be sufficient reason to distinguish the two transactions. Tax and financial accounting often differ;\textsuperscript{83} for example, other types of transactions that qualify as capital contributions for tax purposes, such as debt forgiveness, are not capital contributions in the accounting sense.\textsuperscript{84} The distinction in corporate net worth was relegated to a footnote;\textsuperscript{85} even though stock, as opposed to a contribution of cash or a forgiveness of debt, is not considered an asset that increases corporate net worth, this distinction did not impress the Court. Furthermore, the distinction between a surrender, which causes a change in the percentage ownership of stock, and a trad-
tional capital contribution, which does not, was not persuasive to the Court, as not every change in ownership percentage results in immediate tax consequences.

The majority then addressed the issue of whether the Finks actually sustained a loss during the taxable year as required by section 165 of the Code. The Court noted that the ostensible reason for the surrender was to protect or increase the value of the remaining investment in the corporation. Ultimately, no loss would occur if the purpose were achieved. Because no reliable method existed to determine whether the taxpayer would ultimately sustain a loss or a gain on that investment, the transaction did not meet the requirement that a loss be sustained during the taxable year.

Finally, echoing the concerns of the Second Circuit in *Frantz*, the Court remarked that allowing a deduction would encourage shareholders of troubled corporations to convert potential capital losses to ordinary losses through stock surrenders, or to transfer stock rather than property to troubled corporations. Therefore, the Court held that the Finks could not deduct their basis in the surrendered shares but rather would be required to reallocate that basis among their retained shares.

In a single paragraph concurrence in the judgment, Justice Scalia rejected the majority view that a stock surrender closely resembles a contribution to capital. He preferred to characterize the transaction as a capital expenditure made to "increase the value of . . . property" and, therefore, not deductible under section 263 of the Code. Justice Stevens' dissent, however, focused on the broader question of how changes in the tax law should occur. The Finks had relied on a long series of judicial rulings and administrative acquiescences in reporting the ordinary loss on surrender. If such interpretations were incorrect, then Congress, not the courts, was the proper avenue for changing established precedent. Justice Stevens concluded by paraphrasing

86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.* It is questionable whether stock and property are interchangeable in this context.
92. *Id.* at 99-100. Interestingly, the Court reserved judgment on the issue of whether a shareholder who actually gave up control through the surrender could deduct the loss. By analogizing to I.R.C. § 302, the Court implied that if there had been a loss of control of the corporation, the result might have been different. *Id.* at 99 n.15. Justice White objected to this distinction. *Id.* at 100 (White, J., concurring).
93. *Id.* at 100-01 (Scalia, J., concurring in the judgment) (quoting I.R.C. § 263(a)(1)).
94. *Id.* at 101 (Stevens, J., dissenting).
95. *Id.* at 102-06.
Justice Powell's dissent in *Dickman v. Commissioner*:

"In my view, the retroactive application of the Court's holding in a case like this is unfair to the individual taxpayer as well as unwise judicial administration." 97

II. REALIZATION AND RECOGNITION IN THE STOCK SURRENDER CONTEXT

The determination of the proper tax treatment of stock surrenders should not be all that difficult. According to the appellate courts, identifying the essential nature of the shareholder's investment in the corporation will naturally lead to the proper result. But a relationship so imaginary has no essential nature that will dictate tax consequences. The tax consequences of interactions between shareholders and their corporations are the result of explicit and implicit choices about tax benefits, tax burdens, and the timing of each. To illuminate these choices and their implications for stock surrenders, we must return to the basic concepts of realization, recognition and capital recovery.

First, has a realization event occurred? In other words, has the taxpayer suffered a loss in the sense of the income tax laws? Second, if a loss producing realization event has occurred, is recognition of that realized loss appropriate? More simply, should the transaction result in an increase or decrease in taxes for the taxpayer at the time of the event, or should these tax consequences be deferred until a later date? Answers to these questions should make the "essential nature" inquiry irrelevant for resolving the stock surrender question.

A. Realization and Recognition

Realization is one of the more difficult concepts of our income tax system, 98 essentially posing the question of timing: At what point is it possible to determine that gain or loss has been incurred by a taxpayer? One possible approach, guaranteed to reach all of the taxpayer's gains and losses, would be the periodic taxation of a taxpayer's change in wealth by comparing wealth at the end of the period with wealth at the beginning of the period and taxing the difference. 99 Vari-

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97. *Fink*, 483 U.S. at 106 (Stevens, J., dissenting) (quoting *Dickman*, 465 U.S. at 353 n.11 (Powell, J., dissenting)).
99. *J. Sneed*, supra note 98, at 71 n.44.
ous practical or perhaps political considerations, however, have precluded such an approach. Instead, our system has adopted a "transactional" approach in which an exchange must occur (or be deemed to occur) in order for income or loss to be realized. 100

Determining whether a taxpayer has incurred gain or loss through an actual or deemed exchange has not been an easy matter for the courts. The development of the concept of realization in the Supreme Court illustrates a changing concept of income itself. The original concept of realization as a constitutional requirement, requiring severance of income from capital, 101 has given way to a broader definition, 102 which simply requires a change in the form or the extent of the property interest held by the taxpayer as a result of a transaction. 103

The Supreme Court has interpreted the realization concept quite broadly, encompassing most changes in form or extent of property interests, regardless of whether the taxpayer's economic or practical relationship to the asset has changed. 104 While mere appreciation or depreciation in the value of an asset does not result in realization 105 because no change in the nature of the property interest occurs, most qualitative changes do result in realization events. This broad interpretation of realization (within the constraints of the concept of the transactional tax) has established Congress' expansive taxing power, despite the apparently limiting language of the sixteenth amendment. 106

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100. The problem of valuing appreciating or depreciating assets is often given as the reason for the adoption of the transactional approach to realization. See J. Sneed, supra note 98, at 71.

101. In Eisner v. Macomber, 252 U.S. 189 (1920), the Court was presented with the question of whether a pro rata stock dividend resulted in income to the recipient. Clearly, the taxpayer was no richer on the day after the stock dividend than she was the day before, as the corporate pie had simply been divided into a greater number of pieces. However, this was not the basis for the Court's opinion. Rather, the Court held that since no money or other property had left corporate solution, and thus, no income had been severed from the capital investment represented by the shares, the taxpayer had not realized income. Id. at 211.

102. The severance standard for realized income was short-lived. In Koshland v. Helvering, 298 U.S. 441 (1936), a preferred shareholder received a common stock dividend. The Court abandoned the severance test in favor of the rule that the taxpayer need merely receive an interest essentially different from that previously enjoyed in order to realize income. Id. at 446. Accord Helvering v. Bruun, 309 U.S. 461 (1940). In Helvering v. Horst, 311 U.S. 112 (1940), the Supreme Court acknowledged that realization is simply a rule of administrative convenience requiring only that the taxpayer take the "last step" to obtain the fruits of economic gain. Id. at 115. The development of the modern concept of realization has received generous attention by the commentators. See, e.g., J. Sneed, supra note 98; Mertens, supra note 98; see generally R. Magill, Taxable Income (1945); D. Posin, supra note 98.


106. See J. Sneed, supra note 98, at 71.
The second issue, recognition, is also concerned with the timing of taxation. But where the realization question asks whether it is possible to determine a taxpayer's income or loss, the recognition question asks whether the appropriate time has arrived for tax consequences to flow from that determination. Section 1001 of the Code provides for recognition of realized gains and losses on the sale or exchange of property, and section 165 of the Code specifically allows recognition of losses, i.e., a deduction for all losses sustained during the year but not compensated for by insurance or otherwise. Thus, in general, recognition and the resulting tax consequences flow from a realized gain or loss. The recognition rules or, more appropriately, the nonrecognition rules, can act as a congressional or judicial limit on the expanded definition of realization. Even though gains or losses may be realized, it may be more appropriate to defer the tax consequences of the realization event. In certain cases, a congressional or judicial determination may be made that the transaction should remain "open" to defer reckoning of the ultimate gain or loss and the resulting tax consequences. The income tax laws in general, and subchapter C in particular, mandate nonrecognition treatment for a variety of realization events. Determining just when nonrecognition treatment is appropriate is no easy task, but it is crucial to the proper resolution of the Fink dilemma.

B. Unitary versus Fragmentary View of Stock Ownership as Questions of Realization and Recognition

In lieu of addressing the stock surrender situation in traditional terms of realization and recognition, the appellate courts have focused on the shareholder's investment in the corporation as either a unitary or fragmentary investment in the corporation's stock. The fragmentary view treats each share of stock as a separate investment in the company, and accordingly, disposition of any share (whether by sale, surrender, or other method) reduces the shareholder's investment and

108. Id. § 165(a).
109. According to Professor Sneed, the expanding concept of realization was a result of the Supreme Court's attempts to establish Congress' broad power to tax despite the apparently limiting language of the sixteenth amendment. Congress, in response to political concerns, was more concerned with how that power was to be used and, therefore, developed the nonrecognition provisions to avoid the implications of the broad concept of realization. See J. Sneed, supra note 98, at 65-76.
110. For example, I.R.C. § 1031, although currently under Congressional attack, has traditionally allowed nonrecognition treatment for like kind exchanges. For a discussion of some specific nonrecognition rules of subchapter C, see infra notes 173-200 and accompanying text.
“closes” the transaction with respect to the investment represented by that share. Thus, gain or loss is reckoned with respect to that share at that time. Under the unitary view, if a surrender of shares is made to benefit the remaining shares, the “loss” is treated as an expenditure designed to preserve the value of the remaining shares. Because the effect of the stock surrender on the shareholder’s investment in the corporation as represented by the retained shares cannot be determined at the time of the stock surrender, there is no loss realization under the unitary view.

The fragmentary and unitary views are more useful as illustrations of the fundamental questions of realization and recognition than as descriptions of the essential nature of the stockholder’s investment in a corporation. The fragmentary approach illustrates the general rule that dispositions of stock, whether between individual taxpayers or between the shareholder and the corporation, result in realization of gain or loss to the shareholder. The unitary approach, however, while acknowledging realization of gain or loss, limits recognition of realized gain or loss in certain situations, relying on congressional mandate. In order to resolve the stock surrender dilemma, it is useful to focus on these questions: Do stock surrenders result in realization events, and, if so, should the realized loss be recognized under the general principles of recognition and nonrecognition provided by subchapter C?

C. Stock Surrenders as Realization Events

The policy decision to have a separate tax on corporate income requires that the corporation and the shareholder be considered inde-

111. For example, the sale of shares to a third party would be a transaction in which the fragmentary view would be appropriate. Frantz v. Commissioner, 784 F.2d 119, 123-26 (2d Cir. 1986), cert. denied, 483 U.S. 1019 (1987).

112. The courts have been understandably vague as to whether no realization event (loss) has occurred, or whether a realization event has occurred but recognition is inappropriate. Both the Schleppy and Frantz courts had difficulty seeing any loss at all, but suggested that if a shareholder significantly reduced his interest in the corporation by giving up control, a loss might be realized. Frantz, 784 F.2d at 126; Schleppy v. Commissioner, 601 F.2d 196, 198 (5th Cir. 1979). The Sixth Circuit in Fink objected to this construction of the problem; either the surrender resulted in a realized loss or it did not, but recognition is a separate question. Fink v. Commissioner, 789 F.2d 427, 432 (6th Cir. 1986), rev’d, 483 U.S. 89 (1987). This distinction does not affect the result to the taxpayer. If no realization event occurs, the taxpayer would have no gain or loss to recognize, and would retain her total basis in the investment, allocated (presumably) among the remaining shares. If a realization event had occurred, but recognition was inappropriate, again no gain or loss would be recognized, but would be preserved for later recognition through allocation of basis to the remaining shares. The distinction is important, however, in determining the proper resolution of the stock surrender question.
STOCK SURRENDERS

pendent taxable entities for federal income tax purposes.113 Because a shareholder and a corporation must be respected as separate entities, they may, theoretically, deal with each other as unrelated parties in various transactions. Examples of this fundamental principle abound. A stockholder may buy property from or sell property to a corporation and may lend money to or borrow money from a corporation. These transactions can, absent recharacterization, qualify as transactions between unrelated parties. Furthermore, transactions in the corporation’s stock between the corporation and the shareholder are often treated as transactions giving rise to possible income or loss. Redemptions, liquidations and reorganizations are just three examples of this principle, and as the ones most relevant to the stock surrender situation, are discussed in some detail below.114 The important point is that transactions between the corporation and a shareholder in corporate stock can be considered transactions between separate entities producing realized gain or loss.

The more specific question is whether the surrender of stock by the shareholder to the corporation results in a realized loss. Faced with similar facts, the Second and Sixth Circuits reached dramatically different answers to this question. The Second Circuit perceived no loss at all,115 while the Sixth Circuit found that the Finks had plainly suffered a loss.116

The realization question is essentially one of change: Was the Finks’ interest in Travco after the surrender essentially different, qualitatively or quantitatively, than their interest before the surrender? Prior to the surrender, the Finks owned 72% of Travco stock; after the transaction they owned 68%.117 The Service argued that this four percent reduction did not represent an essentially different interest in the corporation because the Finks remained in control of the corporation after the transaction. Fink agreed that he and his wife remained in control of the corporation,118 but argued that control was not the only relevant incident of stock ownership to be considered. In surrendering four percent of the shares, the Finks had irretrievably given up two

114. See infra notes 173-200 and accompanying text.
115. See supra notes 45-60 and accompanying text.
116. See supra notes 61-75 and accompanying text.
117. Fink, 789 F.2d at 434 (Joiner, J., dissenting).
118. The taxpayers would have given up control of the company had the financing plan been successful. Because losses are deductible only in the year sustained, the contingent divestiture was not considered a current reduction in control giving rise to a loss. Commissioner v. Fink, 483 U.S. 89, 97-98 (1987).
other important interests in the corporation: liquidation value and dividend rights. If the corporation had been liquidated the day after the surrender, they would have received four percent fewer assets. In addition, their dividends would be reduced by four percent if the corporation were to pay dividends. Thus, their interest in post-surrender Travco was different, in both extent and form, than their interest prior to the surrender.

The Service's emphasis on control, however, is not unwarranted. In the close corporation context, in which the stock surrender cases almost always will arise, control through stock ownership may be crucial to continued employment, compensation packages and other benefit arrangements. Minor reductions in shareholdings will not result in any practical difference in corporate operations if the post-surrender ownership percentage exceeds the statutory minimum required for major corporate decisions such as mergers, liquidations or the sale of assets other than in the ordinary course of business. In these cases, the shareholder remains in effective control regardless of the surrender.

To further complicate matters, the inability of troubled corporations to pay dividends lessens the importance of dividend payments in the stock surrender context. Furthermore, because most or all of the assets of troubled companies such as Travco will often be pledged to creditors, current liquidation value may be illusory. These practical realities suggest that the Service is correct in focusing on changes in control to determine whether a taxpayer has an essentially different interest in a corporation after a stock surrender. However, several arguments militate against focusing on control as the sole measurement of an essential change in property interest.

Most fundamentally, in making the realization inquiry, the courts have focused on whether a change of taxpayer interest has occurred, not the magnitude of that change. No de minimis rule exists. The

119. For example, under Florida law, a dissolution requires the support of only a simple majority of the voting stock. However, if provided for in the articles of incorporation, a majority of each class of shares may be required. Fla. Stat. § 607.257(3) (1987). A merger also requires only a simple majority of the voting shares, unless the articles of incorporation of either of the old corporations, or the newly formed corporation, require a majority of each class. Id. § 607.221(2). By contrast, Texas requires a two-thirds vote of all shares of stock to approve a merger or liquidation. Tex. Bus. Corp. Act Ann. art. 6.03 A(3) (Vernon 1980) (liquidations). The articles of incorporation in Texas, however, may provide that the approving percentage be greater or less than two-thirds, as long as the stated percentage exceeds 50%. Tex. Bus. Corp. Act Ann. art. 9.08 A (Vernon 1980).

120. The Service took this position in Fink and Frantz despite the emphasis on liquidation and dividend rights as crucial incidents of stock ownership in other contexts. See, e.g., Rev. Rul. 79-163, 1979-1 C.B. 131.
clearest example of this is the sale of a single share of corporate stock by a shareholder for cash to an unrelated third party. In this situation, a realization event occurs, which requires recognition of gain or loss on the shareholder's investment in the corporation represented by the stock sold. A transaction has taken place in which the selling shareholder has received an amount of money in lieu of the share of stock. Because money is an asset essentially different from stock, a realization event has occurred and the shareholder realizes gain or loss on the investment in the share. This is true regardless of whether the stock sold represented a significant control interest, a realistic prospect of dividends, or substantial liquidation rights.

The selling shareholder gives up the bundle of rights that accompany that share, i.e., voting rights, dividend rights, and liquidation rights, in exchange for cash. The Finks gave up a small percentage (four percent) of similar rights in Travco but received nothing in return. Owning nothing is essentially different from owning that small bundle of rights. Thus, it seems that a realization event had occurred in the life of the Finks.121

Finally, the Supreme Court's broad definition of realization precludes a restrictive interpretation of the change in the Finks' property interest. The Court's path to a broad congressional taxing authority was an expansive definition of realized gains. This expansive definition of realization allows tax consequences to flow from most transactions, and places the decision of whether to tax squarely within the political arena through the concept of recognition. Congress may require recognition of gain and allow recognition of loss; it may allow nonrecognition of gain and mandate nonrecognition of loss; or it may take a "heads-I-win-tails-you-lose" approach by requiring gain recognition and loss nonrecognition. The essential question for the Finks, therefore, is not whether loss has been realized, but rather whether Congress will allow recognition of it.

In Fink the Supreme Court appeared to acknowledge the realization and recognition dichotomy, at least implicitly, by basing its decision on recognition.122 In discussing the capital contribution theory,123 the Court implicitly acknowledged that a realization event had occurred;

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121. Furthermore, by taking the Service's argument that control is the sole determinative factor to its logical extreme, then the stock of the minority shareholders becomes worthless. This result is clearly contrary to both case law and statute. In general, stock becomes worthless upon events that result in a total destruction of its value. This is established by an examination of all the facts and circumstances of the situation which bear upon value. E.g., Mahler v. Commissioner, 119 F.2d 869 (2d Cir.), cert. denied, 314 U.S. 660 (1941).

122. Fink, 483 U.S. at 99-100.

123. Id. at 94-96.
every capital contribution is a realization event, which, but for specific Code provisions, will result in recognition of gain or loss. However, the Court's discussion of whether an economic loss had been sustained is somewhat inconsistent with this view. Logic would seem to dictate that a realized loss had been sustained, which was precluded from recognition by a specific Code provision or judicial principle. While this may be what the Court meant, it is not what the Court said. Rather, the Court suggests that no loss has been sustained, which, under the analysis above, would be incorrect. Finally, a similar ambiguity exists in the Court's suggestion that a sizable surrender, resulting in a loss of control, might result in a deductible loss. The determination of whether a loss has been realized, and, if so, whether it should be recognized, becomes hopelessly complex. How much simpler it would be to address the issue of realization and recognition separately, acknowledging that a realization event has occurred and addressing whether Congress has specifically limited recognition.

**D. Recognition of Realized Loss**

The answer to the recognition question depends on Congress' intent as provided by statute. As noted above, section 165 of the Code allows a deduction for all losses incurred (realized) by a taxpayer and not compensated for by insurance or otherwise. This provides the general rule that realized losses are to be recognized. The issue is whether a specific limitation exists to prevent the recognition of the realized loss in the particular situation. Because no Code section specifically addresses stock surrenders, reference must be made to the more general Code sections governing loss limitations.

1. **Section 267: Denial of Loss on Sales or Exchanges Between Related Parties**

Section 267 of the Code defers recognition of an otherwise deductible loss if it results from a sale or exchange of property between related parties. A related party includes a shareholder owning, directly

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124. *Id.* at 96-97.
125. *Id.* at 99 n.15.
126. *See supra* note 108 and accompanying text.
127. *E.g.*, I.R.C. §§ 166, 267. While the passive loss limitations enacted by The Tax Reform Act of 1986 might seem to limit the deductibility of losses on stock surrenders, in fact, these limitations do not preclude the deduction. The definition of passive losses specifically excludes "gain or loss attributable to the disposition of property" producing income such as dividends. I.R.C. § 469(e)(1)(A)(ii).
or indirectly, more than 50% in value of a corporation's stock.\textsuperscript{129} Although the Service has invoked section 267(a) in disallowing losses on redemption of stock, the use of the section to deny a deduction in stock surrender situations is questionable because of the absence of a "sale or exchange of property." Indeed, the Supreme Court opinion acknowledged this problem, remarking that a "voluntary surrender, for no consideration, would not seem to qualify as a sale or exchange."\textsuperscript{130} Some commentators have suggested use of a "deemed" exchange in which the stock surrender is deemed to be in consideration for the corporation's implied promise to locate outside investors.\textsuperscript{131} While such an approach would produce a capital loss at best, the Service has not found it necessary to rely on a deemed sale or exchange approach.\textsuperscript{132}

The Code's failure to impute the missing sale or exchange element to the stock surrender transaction is clearly inconsistent with its approach in similar areas. When a taxpayer's stock becomes worthless, for example, I.R.C. § 165(g) provides the sale or exchange element to the event of worthlessness so that the loss will be capital in nature. Similarly, the withdrawal of a partner from a partnership for no consideration or consideration in an amount less than the partner's basis (whether by liquidation, abandonment or forfeiture) would appear to create a capital loss because section 731(a) makes the transaction a sale or exchange of a capital asset.

The Code requires capital loss treatment for such transactions in order to prevent such losses from acting as a shelter to ordinary income. In other words, these provisions require that losses attributable to these assets will only offset gains from similar assets. Thus, these provisions were the precursors to the passive loss provisions of the Tax Reform Act of 1986.\textsuperscript{133} This rationale is equally applicable in the stock surrender context because allowing an ordinary loss upon surrender of stock will offset such losses against income from sources other than stock or similar capital assets. Because the taxpayer has more control over the timing of a stock surrender than over the timing of stock worthlessness, stock surrenders provide an even greater op-

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{129} Id. § 267(b)(2).
\item \textsuperscript{130} Commissioner v. Fink, 483 U.S. 89, 98 n.13 (1987).
\item \textsuperscript{131} See, e.g., Keller, supra note 6, at 755.
\item \textsuperscript{132} At oral argument before the Supreme Court, counsel for the Commissioner rejected such an approach, preferring to bypass section 267 in favor of relying on the stock surrender as a capital contribution or expenditure, which precluded realization or recognition of the loss altogether. See Official Transcript of The Supreme Court of the United States at 11, Commissioner v. Fink, 483 U.S. 89 (1987) (No. 86-511).
\item \textsuperscript{133} 26 U.S.C. § 469 (Supp. 1987).
\end{itemize}
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portunity for shelter than the purchase of soon to be worthless stock. Accordingly, the Code could logically provide the missing sale or exchange element to conform the treatment of stock surrenders with the stock worthlessness provisions. This treatment would produce capital loss treatment within the limitations of section 267.

2. Section 263: Capital Expenditures

Section 263 of the Code denies deductions for capital expenditures, which are generally defined as amounts paid for new buildings, permanent improvements or betterments, or amounts paid to increase the value of any property. The usual capital expenditure is a purchase of an asset. Purchases are generally not realization events giving rise to income or loss. Thus, the first question is whether a loss realization event can produce a "capital expenditure" at all. Events giving rise to realized income or loss also may qualify as capital expenditures, although it is often difficult to distinguish between a realized, deductible loss and a realized loss constituting a nondeductible capital expenditure. The Service suggested two arguments to disallow the loss. First, the surrender of stock was essentially a contribution to the capital of Travco, and as such, was nondeductible. Alternatively, the purpose of the contribution was to benefit the remaining shares, and therefore the surrender was a capital expenditure.

a. Contribution to Capital

As discussed above, the contribution to capital of cash or other property to a corporation by a shareholder would certainly be a transaction resulting in a change in interests, and thus, a realization event. However, because the transaction is viewed as additional payment for

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134. I.R.C. § 263(a).
135. Treas. Reg. § 1.263(a)-1(a) (as amended in 1987). The Regulations continue, providing: In general [capital expenditures] . . . include amounts paid or incurred (1) to add value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures.

Id. § 1.263(a)-1(b).
136. E.g., Ingle v. Gage, 52 F.2d 738 (W.D.N.Y. 1931); Citizens Nat'l Bank v. Commissioner, 42 B.T.A. 539 (1940), aff'd, 122 F.2d 1011 (8th Cir. 1941), cert. denied, 315 U.S. 822 (1942).
138. See supra notes 113-25 and accompanying text.
the corporation’s stock, it is deemed a nondeductible capital expenditure for which nonrecognition treatment is appropriate. Thus, the Treasury Regulations state that “voluntary contributions by shareholders to the capital of the corporation for any corporate purpose” are “capital investments and are not deductible.”140

A contribution to capital may consist of cash or any other type of property. If a shareholder intends to commit funds or assets to the risks of the business, the shareholder has made a capital contribution, regardless of the particular label affixed to the transaction.141 A capital contribution also may be made by a shareholder gratuitously forgiving a debt of the corporation.142 The Supreme Court’s selection of this type of transaction as the proper template for stock surrenders raises interesting issues.

The discussion of shareholder forgiveness of corporate debt in the majority opinion begins with the generally accepted proposition that when a shareholder makes an outlay to benefit the corporation, the shareholder cannot claim a loss for the expenditure.143 What this really means is that the shareholder may not claim a deduction for such an outlay as an ordinary and necessary expense of carrying on a trade or business under section 162 of the Code. Because of the long-standing principle that the corporation and the shareholder are separate taxable entities and must be respected as such,144 the trade or business of the corporation cannot be imputed to the shareholder to allow the shareholder to deduct the expenditure.145 Rather, the shareholder must establish the deductibility of the expense as necessary to the shareholder’s own trade or business. Because the holding of stock for investment purposes does not normally rise to the level of a trade or

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139. See Treas. Reg. § 1.118-1 (1956), stating that voluntary pro rata payments by the shareholders are “in the nature of assessments upon, and represent an additional price paid for” stock.

140. Treas. Reg. § 1.263(a)-2(f) (as amended in 1987).

141. See also United Grocers, Ltd. v. United States, 186 F. Supp. 724 (N.D. Cal 1960), aff’d, 308 F.2d 634 (9th Cir. 1962).

142. Commissioner v. Fink, 483 U.S. 89, 94 (1987) (citing Deputy v. Dupont, 308 U.S. 488 (1940); Eskimo Pie Corp. v. Commissioner, 4 T.C. 669, 676 (1945), aff’d, 153 F.2d 301 (3d Cir. 1946)).


business, the taxpayer is not entitled to a deduction but instead must capitalize the outlay, adding the expense to the basis of the shares.

Whether a similar limitation applies to losses was the problem faced by the Court in *Fink*. Distinguishing expenses and losses is difficult because both involve a parting with something of value by the taxpayer, and both expenditures and losses may take many forms. For these purposes, however, a general definition of losses as a "[f]ailure to keep that which one has" will suffice in the sense that it implies a prior capital investment that is impaired by some event.

In searching for a loss event that is similar to a stock surrender, the *Fink* Court focused on the position of a creditor of a corporation who forgives the debt. A creditor makes a capital investment in the amount of the principal of the debt, and has an ongoing right to interest payments. When the debt is forgiven, the capital investment and ongoing income stream are lost, producing a loss which is capable of recognition in accordance with the provisions of section 165 of the Code. This seemed to the Court a logical choice for analyzing stock surrenders because in the latter case the shareholder also loses both a capital investment and a potential income stream. Historically, a shareholding creditor has not been allowed a deduction for the loss upon the forgiveness of a corporate debt. Instead, the forgiveness has typically been characterized as a capital contribution by the shareholder to the corporation, reflecting the resultant increase in equity.

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146. Id. at 495-96.
147. See Williamson v. Commissioner, 100 F.2d 735, 738 (6th Cir. 1938); Fairmount Foundry, Inc. v. Commissioner, 42 B.T.A. 1087 (1940).
149. A discussion of the infinite variety of events producing a realized loss is beyond the scope of this article. See generally Mertens, supra note 98, at § 28.05.
151. Id.
152. The central issue for the courts has been whether the debtor corporation realizes income on the forgiveness of the debt. Under prior law, two principal cases formed the basis for determining whether the debtor realizes income when a debt is forgiven. In Helvering v. American Dental Co., 318 U.S. 322 (1943), aff'd 128 F.2d 254 (7th Cir. 1942), the gratuitous cancellation by a taxpayer's creditors of rent and interest on debts owed was likened to a gift by the creditor to the taxpayer, resulting in no income to the debtor taxpayer. Id. at 329-31. By contrast, in Commissioner v. Jacobson, 336 U.S. 28 (1949), rev'd 164 F.2d 594 (7th Cir. 1947), the taxpayer purchased his outstanding bonds for less than their face amount in arm's length transactions with the holders of the bonds. The *Jacobson* Court limited *American Dental Co.* to those situations in which a gift was intended. *Jacobson*, 336 U.S. at 51. Under the *Jacobson* facts, the taxpayer did not intend to transfer something for nothing; rather, he and his creditors were simply trying to make the best possible deal to retire the taxpayer's outstanding indebtedness. Id. The difference between the face amount and the acquisition price was not a gift from the creditors to the taxpayer. *Id.* Therefore, under the *American Dental Co.* and *Jacobson* line of cases, a
capital made available to the corporation by the forgiveness. Using this approach in stock surrenders would preclude recognition of the surrendering shareholder’s loss, on the theory that the surrendering shareholder “expends” the capital represented by the shares to benefit the corporation. Although this theory offers an attractive means of denying the Finks’ loss, it ignores a basic difference between the two situations. The economic consequences of a stock surrender differ quite dramatically from those of a capital contribution. Net corporate capital does not increase as a result of a stock surrender. The corporation may either cancel the surrendered shares or hold them as treasury stock, but in either event, the stock has no intrinsic value (unlike cash or other property) to the corporation except as a potential means of raising capital. By contrast, in a capital contribution, the stockholders’ equity increases as the assets held by the corporation increase.

gratuitous forgiveness of debt is a gift, resulting in neither income to the debtor nor a realization event to the creditor. On the other hand, a nongratuitous forgiveness results in income to the debtor and a realization event to the creditor. The Treasury Regulations incorporate this distinction by providing that the gratuitous forgiveness of indebtedness by a shareholder results in a capital contribution to the debtor corporation. See supra note 142. By negative implication, the nongratuitous forgiveness of indebtedness does not result in a capital contribution.

Section 108(e)(6) of the Code now statutorily incorporates this distinction. The general rule that income will result from a discharge of indebtedness applies when a shareholder forgives a corporate debt “as a contribution to capital,” but the corporation is deemed to have satisfied the debt with an amount of money equal to the shareholder’s adjusted basis in the indebtedness. I.R.C. § 108(e)(6)(B). Shareholder forgiveness of debt which is not made as a contribution to capital is governed by the general discharge of indebtedness rules. Thus, in any situation in which a shareholder forgives a loan to the corporation, the first question is whether this action occurred as a contribution to capital.

A shareholder makes a contribution to capital when the action of forgiving the debt relates to her status as a shareholder. If the shareholding creditor were merely trying to maximize satisfaction of a claim, no contribution to capital would occur. To distinguish between the two, an analysis of all of the facts and circumstances of the situation must be made. SENATE COMM. ON FINANCE, BANKRUPTCY TAX ACT OF 1980, S. REP. NO. 1035, 96th Cong., 2d Sess. 18 n.21, reprinted in 1980 U.S. CODE CONG. & ADMIN. NEWS 7017, 7033 n.21. Even though the Committee Reports specifically state that no commercial gift exception is intended to discharge indebtedness income, the analysis required for a capital contribution closely resembles the Jacobson Court’s distinction between a gratuitous and nongratuitous transfer: The inquiry into each transaction must be a factual one, turning on whether it is a transfer of something for the best price available, in which case no gift occurs, or whether it is intended to be a transfer of something for nothing. Jacobson, 336 U.S. at 51.

The tax treatment of the forgiving shareholder has taken a back seat to the primary issue of whether the debtor has income. However, upon forgiveness of a debt, a shareholder may claim an ordinary or capital loss in the amount of the forgiven debt. For example, in Perlman v. Commissioner, 252 F.2d 890 (2d Cir. 1958), a corporation accrued but did not pay a portion of a shareholder/employee’s salary. The shareholder nevertheless included the amount in income. In a later year, the shareholder reluctantly agreed to forego the unpaid portion altogether, because payment would have jeopardized the financial position of the company. He then claimed an ordinary loss in the amount of the forgiven debt. The Second Circuit succinctly characterized this amount as a contribution to capital, and as such nondeductible. Id. at 892.
This is also true of forgiveness of debt owed to a shareholder by the corporation because it becomes part of the equity of the corporation, increasing the corporation’s net worth, just as if the funds had been contributed directly as capital. Furthermore, a stock surrender results in a transfer of value from the surrendering shareholder to the nonsurrendering shareholders: although corporate capital remains constant, a portion of that value is transferred to the other shareholders.\footnote{153}

These distinctions are crucial because the rationale for nonrecognition in capital contribution cases is absent from stock surrender situations. The recognition system governing capital contributions allows the shareholders to do after the fact what they could have done in the creation of the corporation, with the same tax consequences. In a capital contribution, the shareholders may transfer additional property pro rata to the corporation; they will recognize none of the lurking gain or loss inherent in the asset and will add to the basis in their stock the basis of the asset transferred. Similarly, any shareholder may make a non pro rata contribution, recognizing no gain or loss on the transfer of the asset and adding the basis of the property transferred to the share basis. Corporate capital will increase, and a portion of the value will be transferred to the other shareholders because the contributing shareholder does not take additional stock.

\footnote{153. The Supreme Court failed to find this distinction convincing, stating that it had “never held that every change in a shareholder’s percentage ownership has immediate tax consequences.” Fink, 483 U.S. at 97-98. The Court is indeed correct in stating that not every change in percentage ownership results in recognition. While a sale of shares among shareholders to effect a reallocation of ownership would certainly result in recognition, certain other transactions will not produce immediate tax results. For example, a simple non pro rata stock dividend will not result in a recognition event to the recipients. I.R.C. § 305(a). In contrast, the distribution of cash or other property to the shareholders who did not receive stock will transfer the transaction into a taxable event for the stock recipients. Id. § 305(b)(2).

The statutory recognition scheme for stock dividends is rather complex. See B. BITTKE & J. EUSTICE, supra note 141, at ¶ 7.40-.44. This complexity is a function of the tension between (1) the continuing expansion of the realization doctrine, see supra notes 98-110 and accompanying text, in light of transactions in which no assets leave corporate solution, and in which the recipient is in no better situation (a scenario in which nonrecognition is appropriate); and (2) the continuing imagination of lawyers who create stock dividends which grant shareholders the benefits of a dividend without dividend treatment (a scenario in which recognition is appropriate), in particular the preferred stock bailout. See Clark, supra note 113, at 118-20. It is not the change in percentage interests that is crucial but rather the potential for bail out of earnings. The change in percentage interests is only one indicia of bail out potential. Applying this recognition scheme to determine the tax fate of a stock surrender, however, seems rather inappropriate because the bail out of earnings is not the objective of the action. A capital contribution, even if non pro rata, also results in a transfer of value from the contributing shareholders to the noncontributing shareholders, but the item transferred is a portion of the increase in corporate capital, not a portion of the shares.}
Doctrinally, Congress and the courts have explained nonrecognition of realized gains in the organization/capital contribution situations as a response to the idea that corporate organizations are mere changes in form, not substance, and as such, should not be subject to tax. If this were true, the elective characteristics of section 351 of the Code would hardly seem appropriate; transferors can recognize losses inherent in transferred assets by structuring the transaction to fall outside the requirements of section 351 of the Code or constructing the transaction as a sale. Rather, it is more likely that the optional nonrecognition rules applicable to an organization/capital contribution situation simply facilitate the pooling of resources in corporate form throughout the corporate lifetime, probably in response to Congress' notions of optional industrial organization and in order to collect corporate taxes, a significant source of revenue. Imposing a tax on the contribution of property or disallowing losses on such contribution would interfere with creation of corporations, and thus, the quasi-elective nonrecognition rules apply.

The traditional justifications for nonrecognition in the organization/capital contribution contexts do not apply in the stock surrender situation. Because no increase in corporate assets occurs, there is no mere change of form of any assets to require a nonrecognition rule. Similarly, a stock surrender involves no additional pooling of resources that would be encouraged by a nonrecognition rule. In summary, the essential problem of using capital contribution theories as the template for stock surrenders is that stock surrenders simply are not capital contributions. Indeed, applying the rules developed for capital contribution situations to stock surrenders does not make sense because the concerns producing those rules are not present in the stock surrender case. A more productive path might be found in the rules developed specifically to limit losses in the capital expenditure context.

155. I.R.C. § 351 provides nonrecognition treatment to realization of recognized gains and losses if the specific requirements of that section are met. If these requirements are not met, recognition is required. Because planning for recognition or nonrecognition is relatively easy, section 351 has a somewhat elective aura. See B. Bittker & J. Eustice, supra note 141, at ¶ 3.10.
156. However, the transferor may be precluded from taking a loss due to I.R.C. § 267 or its judicial penumbras. Higgins v. Smith, 308 U.S. 473 (1940). See, e.g., Ellis, Tax Problems in Sales to Controlled Corporations, 21 Vand. L. Rev. 196 (1968).
157. The corporate income tax became a significant source of federal revenue, raising $21 million in 1909, the year of its enactment, and increasing to $35 million by 1912. S. Rantner, American Taxation 297 (1942).
b. Capital Expenditures

The better argument for the Service in the stock surrender situation is that the stock surrender should not be viewed as a closed and completed transaction. Rather, even though a loss may have been realized through the surrender of stock, this loss is a capital expenditure and is therefore nondeductible. The majority opinion in *Fink* touched upon this issue as part of its overall discussion of the capital contribution theory,¹⁵⁸ and Justice Scalia specifically rejected the capital contribution theory as a basis for his concurrence in the result, preferring instead the more general capital expenditure theory, without any discussion of the rationale for his preference.¹⁵⁹

The capital expenditure argument assumes that because the taxpayer's purpose is to avoid loss of the equity investment in the company, recoupment of the capital represented by the surrendered shares is reasonably anticipated. When recoupment is reasonably likely, no loss is recognized, and the transaction remains open until it is possible to determine whether recoupment has occurred. Few analogous situations appear to exist, but the building demolition cases and regulations offer some examples. In these cases, the taxpayers acquired property upon which old buildings were located. They demolished these buildings for various reasons, including to construct a new building¹⁶⁰ and to make the land available for parking.¹⁶¹ The question presented in these cases was whether the loss incurred in demolishing the building (costs of demolition and the unrecovered basis of the building) were currently deductible or were to be added to the basis of the land or new building. The Treasury Regulations reflected the judicial approach to the problem. Accordingly, if the building and the land on which it was located were not acquired with the intent to demolish the building, it was appropriate to allocate a portion of the purchase price to the building. Subsequent demolition resulted in a deductible loss to the extent of unrecovered basis in the property and the costs of demolition.¹⁶² However, if the taxpayer acquired the land with the intent to demolish the building, these costs were to be added to the basis of land on which the demolished structure was located.¹⁶³ In recognition of the problems inherent in any intent inquiry, Con-

¹⁵⁹. *Id.* at 100-01 (Scalia, J., concurring in the judgment).
¹⁶⁰. Commissioner v. Appleby's Estate, 123 F.2d 700 (2d Cir. 1941).
¹⁶³. *Id.* § 1.165-3(a)(1); e.g., Fillmore Gardens Shopping Center, Inc. v. United States, 327 F. Supp. 973 (E.D. Va. 1971); Garrett, 25 T.C.M. (CCH) 879.
But prior to the enactment of section 280B, the courts approached the problem of capital expenditure versus deduction posed by these cases as a question of closure. When the taxpayer's plan at the time of purchase was to demolish the structure, it was clear that the taxpayer received value for the old building at least equal to the taxpayer's investment by substituting a more valuable asset (the newly erected building or the parking lot, for example) for the old asset. Substitution of a more valuable asset does not lead to loss because the investment of capital in the old asset is reasonably likely to be recouped by substitution of the new asset. Recoupment is reasonably likely because the taxpayer simply would not have consummated the transaction unless the value of the new asset exceeded, or had the prospect of exceeding, the value of the old asset. Therefore, the transaction remains open with respect to the investment until ultimate disposition.

These cases may be contrasted with those in which the demolition decision was made in response to defects discovered after purchase or other subsequent events. In such situations, losses were allowed on the theory that no substitution of assets had occurred. Since the demolition occurred to protect the value of the original investment rather than to create a new and different asset, the transaction could properly be considered closed with respect to the old asset, and thus, loss could be recognized.

The issue presented may best be understood as the loss analog to the expense versus capital expenditure question presented by the more common repair cases. In the repair cases, the question of closure again arises, but is couched in terms of whether a significant expense giving rise to benefits that last beyond the taxable year is a capital expenditure or a deductible expense. In *Midland Empire Packing Co. v. Commissioner*, for example, the taxpayer constructed a concrete sheath for its meat storage basement to protect the meat from oil seepage emanating from a nearby refinery, which, left unchecked, would have endangered the taxpayer's entire operation. While an expenditure of this type might ordinarily be considered a capital expen-

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165. Commissioner v. Appleby's Estate, 123 F.2d 700, 702 (2d Cir. 1941).
166. *E.g.*, Union Bed & Spring Co. v. Commissioner, 39 F.2d 383 (7th Cir. 1930); Chesbro v. Commissioner, 21 T.C. 123 (1953), aff'd, 225 F.2d 674 (2d Cir. 1955), cert. denied, 350 U.S. 995 (1956).
167. 14 T.C. 635 (1950); accord American Bemberg Corp. v. Commissioner, 10 T.C. 361 (1948).
diture because of its usefulness beyond the current year, the court focused not on the nature of the expenditure itself, but rather on the taxpayer’s purpose in expending the funds and the ultimate economic result. The taxpayer’s purpose was protection of its ongoing plant operations and the expenditure itself resulted in no new or different asset in form or in function.\textsuperscript{168} Therefore, the expenditure qualified as a deductible repair expense rather than a capital expenditure.\textsuperscript{169}

In both the demolition and repair cases, no inquiry is made into the possibility of recovery of capital, however likely or remote that possibility might be. This may result from the difficulty in determining the likelihood of such recovery.\textsuperscript{170} The distinction remains that losses and expenses incurred for the purpose of “repairing” the ongoing investment are deductible while expenditures for creating, enlarging or changing an investment are properly chargeable to the capital account.

Applying these principles to the stock surrender situation, it appears that both the Service and the courts are indeed focusing on the taxpayer’s purpose in determining whether a capital expenditure has been made in the stock surrender context. However, the taxpayer’s purpose must be analyzed in terms of the possibility of recoupment of the capital invested in the surrendered shares. If the purpose (and result) of the transaction were the substitution of a new, enlarged or different asset for the surrendered shares, the capital expenditure limitations of section 263 of the Code should apply to keep the transaction open until disposition of the remaining shares, because recovery of the capital investment in the surrender shares is reasonably likely. However, if no such substitution has occurred, because the taxpayer’s purpose was merely to maintain the value of the ongoing investment, without substitution, the result of the closed and completed transaction should be a deductible loss.\textsuperscript{171}

In the usual stock surrender cases, protection of the taxpayer’s ongoing investment, not substitution of a new, different or enlarged in-

\begin{footnotes}
\item 168. Midland Empire Packing Co., 14 T.C. at 642.
\item 169. Id. at 642-43.
\item 170. On the other hand, this construct may be a tool designed to encourage taxpayers to maintain their investments in good repair and to keep the investment afloat for as long as possible.
\item 171. The substitution doctrine provides an alternative means of analyzing the forgiveness of debt problem discussed above. See supra notes 142-52 and accompanying text. When the shareholder creditor forgives the debt, the question arises whether the taxpayer has substituted another asset, the equity investment, for the forgiven loan. Because of the different nature of the equity and debt assets, the substitution doctrine would appear to properly preclude loss recognition. Such analysis allows continuing respect for the different roles of the shareholder and creditor, unlike the gratuitous/nongratuitous rationale.
\end{footnotes}
vestment, is the taxpayer's motive. The motivation of the taxpayer may be explained as preservation of the capital investment in the remaining shares, not the surrendered shares, as an alternative to loss of the total investment. No substitution of a more valuable asset for a less valuable one actually occurs in the stock surrender situation because the taxpayer neither acquires a new asset nor changes the form of investment. No reasonable prospect exists for recovery of the capital invested in the surrendered shares, because the mere possibility, however likely, that the remaining shares will absorb the loss through subsequent appreciation or profitability does not, according to accepted doctrine, make recoupment of the investment reasonably likely. This seems to be the correct result because of the difficulty in predicting whether the remaining shares will appreciate in value. Furthermore, because surrenders are like repairs to the stock investment, encouraging repairs through surrender will encourage investors to keep their investments afloat for as long as possible. Therefore, it appears that the loss realized by the Finks is not properly characterized as a capital contribution or other capital expenditure, and thus, no specific statutory constraints exist on the deductibility of this loss.

III. RECOGNITION OF LOSSES ON STOCK SURRENDERS WITHIN THE CONTEXT OF SUBCHAPTER C

Although no specific statutory provisions appear to constrain the recognition of losses on stock surrenders, the question remains whether such recognition is appropriate. Answering this question changes the mode of analysis from likening a stock surrender to other, more familiar, transactions (the approach favored by the courts) to an inquiry into how stock surrenders illustrate the recurrent problems of the corporation/shareholder relationship that subchapter C seeks to resolve.

A. Subchapter C

When a transaction involves only events at the shareholder level or only events at the corporate level, the proper tax consequences of the transaction can be determined without reference to subchapter C. For example, the sale of shares by a shareholder to another person involves only a shareholder level transaction, and the shareholder's gain or loss is determined by reference to I.R.C. § 1001, possibly limited by nonrecognition provisions of sections such as I.R.C. § 267. Subchap-

172. In fact, the shareholder's investment is decreased.
173. See generally Clark, supra note 113, at 92-94.
ter C, however, addresses the more problematic transactions, i.e., those between the corporation and the shareholder. The creation, operation and termination of the corporation require many such transactions, which raises fundamental questions regarding whether recognition or nonrecognition of gain or loss is appropriate.

Specifically, recognition questions often involve the timing of capital recovery deductions for a shareholder's investment in a corporation. The creation of the corporation results in two taxable entities, the corporation and the shareholder. The shares received in the exchange, or subsequently, represent the taxpayer's capital invested in the corporation, and capital recovery is not allowed on such shares until disposition. This raises the question of what constitutes a disposition that will trigger capital recovery. When a sale or exchange is made to an unrelated party in a transaction that merely substitutes one shareholder for another, a disposition clearly occurs. The more difficult question is whether a disposition by a shareholder to the corporation is an appropriate time for capital recovery. Subchapter C addresses this issue for several different transactions. For example, the exchange of shares for assets upon liquidation of the corporation is obviously an appropriate time to allow capital recovery of the amount invested in the shares because the shareholder's investment in the corporation terminates. Similarly, section 165 of the Code provides that the worthlessness of corporate stock is an appropriate time for capital recovery, treating the worthlessness as a sale or exchange of the stock. Because of the worthlessness of the shares, the capital allocable to them will never be returned to the shareholder. Therefore, worthlessness can be likened to liquidation as an appropriate time for capital recovery because the shareholder's investment in the corporate venture is terminated.

Congress might have determined that a shareholder's capital recovery is inappropriate at any time short of liquidation or worthlessness.

174. The timing of capital recovery, not its absolute availability, is the question that most often plagues the Service and the courts, and is the subject of statutory attention. See, e.g., Inaja Land Co. v. Commissioner, 9 T.C. 727 (1947), acq. 1948-1 C.B. 2. The question for the shareholder is at what point in time the value of the capital invested may be deducted, either against income produced by the investment, or against other income if the investment produces no income. Shareholders prefer capital recovery to occur as soon as possible, while the Service prefers the opposite approach.

175. I.R.C. § 331.

176. Section 165(g)(1) of the Code allows a capital loss from the sale or exchange of a capital asset for a security (including stock, I.R.C. § 165(g)(2)(A)) that is a capital asset and becomes worthless during the taxable year. This provision is not within the purview of subchapter C because the sale or exchange need not be deemed to be between the corporation and the shareholder.
of the shareholder’s interest in the corporation, but it did not. Instead, the rules of subchapter C allow capital recovery at some points prior to liquidation or worthlessness. Subchapter C generally makes capital recovery in shareholder/corporation transactions dependent upon a meaningful change in the relationship between the corporation and the shareholder, i.e., the withdrawal of a significant measure of the capital from the corporate model by its return to the shareholder. In the absence of such a withdrawal, capital recovery must be deferred.

1. Capital Recovery in Corporation/Shareholder Transactions

This principle can be illustrated by subchapter C’s approach to the various corporation/shareholder transactions that typically occur during the life of a corporation. All of these transactions illustrate the recurrent problem of timing capital recovery.

Most of these transactions involve exchanges between the shareholder and the corporation in which the shareholder receives some payment from the corporation with respect to the shareholder’s stock. The proper characterization of distributions to shareholders with respect to their shares either as corporate earnings, which are subject to the double tax, or as a tax-free return of capital is the crucial issue. While pro rata distributions of earnings and profits from ongoing corporations to shareholders are usually dividends, and distributions in liquidation usually represent, in whole or in part, a return of capital, the most difficult transactions lie somewhere in between these two clear cases. Each distribution must be examined for its essential characteristics as a dividend or return of capital. This issue arises most clearly in the case of redemptions.

In a redemption, a shareholder exchanges stock for cash or other property from the corporation. The essential question is whether the distribution from the corporation to the shareholder represents a return of capital or a distribution of corporate income, i.e., a dividend. If the distribution is classified as a dividend, the shareholder must include the full amount of the distribution in income, to the extent of the shareholder’s pro rata share of the corporation’s earnings and profits.177 However, if the distribution is classified as an exchange of

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177. I.R.C. §§ 301(a), (c), 302(a). To the extent the shareholder does not recover the full amount of the basis in the shares, because the distribution is treated as a dividend, the better view appears to be that the leftover basis is added to the basis of the remaining shares rather than simply disappearing. See generally Kahn, Stock Redemptions: The Standards for Qualifying as a Purchase under Section 302(b), 50 FORDHAM L. REV. 1 (1981); Blumstein, When is a Redemption “Not Essentially Equivalent to a Dividend”? 7 J. CORP. TAX’N 99 (1980).
stock, the shareholder will be entitled to tax-free recovery of basis, and the gain will be classified as capital gain.178

Section 302 of the Code distinguishes between dividend distributions and exchanges in order to prevent the unwarranted "bail-out" of corporate earnings as disguised distributions of capital and capital gain. The history of section 302 illustrates the difficulty in making a determination that satisfactorily distinguishes between the two and provides adequate guidance for taxpayers contemplating a redemption while also protecting the integrity of the double tax base.179 The current statutory scheme provides a safe harbor test for such a reduction that insures a meaningful reduction in shareholder interest180 as well as a more flexible test for redemptions outside the safe harbor.181 A complete termination of shareholder interest will always qualify as an exchange entitled to capital gain treatment since the shareholder is truly giving up all benefits of the corporate form for the investment.182 While the tests of section 302(b) differ in scope and application, they are all designed to allow exchange treatment only when there has been a meaningful reduction in shareholder interest as measured by the shareholder's pre- and post-redemption interest in voting power, earnings and assets. Otherwise, the amount distributed will be a dividend to the shareholder, and subject to taxation, regardless of the reduction in shareholdings accomplished by the redemption.183

Redemption exchanges that result in a gain require dividing the distribution into its income and capital components so that capital may be recovered tax-free. Redemption exchanges that produce a loss, where the total distribution is less than the basis in the redeemed shares, raise an identical question of capital recovery, i.e., whether the

180. Section 302(b)(2) of the Code treats redemption proceeds as gain from the sale or exchange of stock rather than as a dividend if the redemption is "substantially disproportionate." A substantially disproportionate redemption is one in which (1) the shareholder's total ownership of all classes of stock after the redemption is 80% of the shareholder's previous ownership, (2) the shareholder's voting stock is 80% of the shareholder's previous ownership, and (3) the shareholder controls less than 50% of the voting shares after the redemption. Constructive ownership principles apply to determine reductions under these rules. I.R.C. § 302(c).
182. If a shareholder's interest in a corporation is completely terminated, the transaction will qualify as an exchange under I.R.C. § 302(b)(3). In order to completely terminate an interest, the shareholder must give up all shareholdings owned directly or indirectly through constructive ownership. However, the shareholder may waive family attribution so that constructive ownership is not considered in determining whether an exchange qualifies provided the shareholder agrees not to acquire a prohibited interest in the corporation within the ten years following the exchange. Id. § 302(c)(2).
STOCK SURRENDERS

redemption represents a complete return of capital, so that proper measurement of the overall income of the taxpayer requires recognition of the loss. When the consideration paid by the corporation for the shares is less than the basis of the shares, will the redeeming shareholder be entitled to claim a (capital) loss on the transaction? Although section 267 would disallow the shareholder's loss entirely if the redeeming shareholder and the corporation were "related parties," absent application of section 267 and a tax avoidance purpose, the loss should be allowable, if the transaction meets the requirements of section 302. In other words, such a transaction should be classified as an exchange regardless of whether gain or loss is realized on the transaction, and absent application of other Code sections denying recognition of a loss, a shareholder's redemption loss should be deductible. This result, however, has apparently never been litigated.

The redemption transaction does not present the only opportunity for examining the allowance of capital recovery in the shareholder/corporation context. Another example is the consequence of the receipt of boot by a shareholder in a qualifying corporate reorganization. Following the redemption model, boot may be taxable to the shareholder as a return of capital and capital gain or as a dividend. The more interesting aspect of the reorganization model is that a shareholder may never recognize loss on the shares in a qualifying reorganization, even if boot is received. Instead, recognition of loss on the stock is deferred by preserving the loss in the basis of the stock received in the reorganization. If, however, the transaction falls outside the definition of a qualifying reorganization, gain and loss recognition is available to the shareholder as if a sale or exchange had occurred.

185. B. Bittker & J. Eustice, supra note 141, at ¶ 9.01-.35.
187. See id.; Shimberg v. United States, 577 F.2d 283 (5th Cir.), cert. denied, 439 U.S. 1115 (1978); Wright v. United States, 482 F.2d 600 (8th Cir. 1973).
188. I.R.C. § 356(c).
189. Id. § 358(a)(1). For example, assume Shareholder A exchanges stock in Corporation 1 with a basis of $100,000 and a fair market value of $50,000 for stock in Corporation 2 with a fair market value of $40,000 and boot of $10,000, in a qualifying statutory merger of Corporation 1 into Corporation 2. Shareholder A recognizes none of the $50,000 loss inherent in the Corporation 1 shares. I.R.C. § 356(c). Instead, A takes a basis of $90,000 in the Corporation 2 shares ($100,000 - $10,000 = $90,000) pursuant to I.R.C. § 358(a)(1). The $90,000 of basis preserves the entire $50,000 loss that went unrecognized in the merger.
In order to distinguish between the two, subchapter C provides a complex web of definitional rules for reorganizations,190 which are supplemented by the extra-statutory requirements of continuity of shareholder interest, continuity of business enterprise, and business purpose.191 These statutory and judicial requirements ensure that the relationship of the shareholders and the participating corporations will remain substantially intact, distinguishing a reorganization from a sale of shares or corporate assets. When the relationship remains intact, therefore, loss is deferred for later recognition and gain must be characterized as either capital gain or the distribution of earnings, depending on the facts of the particular reorganization.

The redemption and reorganization rules described above illustrate subchapter C's commitment to capital recovery through tax-free recovery of basis or recognition of loss by shareholders prior to liquidation of the corporation or worthlessness of their stock. But capital recovery is not allowed in all of the pre-liquidation shareholder/corporation exchanges in which shareholders might benefit from capital recovery. Rather, subchapter C limits capital recovery to those instances in which a significant amount of capital is withdrawn from the corporate entity and then returned to the shareholder so that there is a meaningful change in the shareholder/corporation relationship.

2. Rationale for the Capital Recovery Standard

As long as a shareholder's investment remains principally in corporate solution, deferral of capital recovery is required. When the shareholder removes a significant portion of that investment from corporate solution, capital recovery is allowed. Why does subchapter C use this standard to determine whether capital recovery is appropriate?

The system acknowledges that accurate measurement of a shareholder's income from the investment in corporate shares requires some allowance for capital recovery both in the distribution context and in the loss context. But the limits imposed on capital recovery serve a different purpose: one often at odds with the goal of accurate measurement of a taxpayer's income. The purpose is the protection of the dual entity, double taxation system imposed by subchapter C, which is based on the fundamental principles that the shareholder and the corporation are separate taxable entities192 and that income and

190. See I.R.C. § 368(a).
192. See I.R.C. §§ 1, 11. These sections are the basis for the double tax of the corporate model.
loss realized at the corporate level are not immediately recognized at the shareholder level.\textsuperscript{193} Congress, the Service, and the courts must be ever vigilant in identifying the distribution of corporate earnings subject to the second level of taxation at the shareholder level. When a transaction between a corporation and a shareholder results in a distribution to a shareholder, this distribution requires careful examination to determine whether the double tax should be imposed. Premature allowance for capital recovery, i.e., tax-free return of basis upon distributions prior to recognition of income, defers collection of the shareholder level tax and is inconsistent with financial accounting theory that the shares are nonwasting assets.\textsuperscript{194}

On the other hand, proper income measurement for the shareholder requires that if the corporation has in fact distributed some or all of the shareholder's capital, the shareholder should be allowed a tax-free return of that capital prior to reckoning gain on the transaction. However, the system assumes that distributions are made from earnings, where available,\textsuperscript{195} unless a fundamental change in the relationship between the corporation and the shareholder exists. When this relationship changes, as in a qualifying redemption or a nonqualifying reorganization, the system assumes that some capital has left corporate solution. As a result, the interests of proper income measurement outweigh protection of the double tax so that capital recovery is allowed.

Recognition of losses at the shareholder level is more problematic. Immediate protection of the double tax does not seem to be at stake since no income is distributed to the shareholder. The real problem here is the protection of the dual entity structure upon which the double tax system is based. A shareholder obtains the benefits of deferral of income\textsuperscript{196} as a necessary corollary of the corporate structure. But the deferral principle burdens the taxpayer as well by precluding immediate recognition at the shareholder level of losses realized at the corporate level. Simply put, in creating the corporation, the taxpayer divorces himself or herself from the tax fortunes of the capital invested in the corporation. Premature capital recovery through loss recognition by a shareholder creates the possibility of deferral of income and current recognition of loss for the same capital investment.

\textsuperscript{193} Compare the treatment of S Corporations, in which no corporate tax is imposed and no deferral principle operates. See I.R.C. §§ 1361-79.

\textsuperscript{194} See supra notes 173-91 and accompanying text.

\textsuperscript{195} See I.R.C. §301(a); Clark, supra note 113, at 106-07.

\textsuperscript{196} Of course, with the reduction of tax rates so that the maximum corporate rate exceeds the maximum individual rate for the first time in history, this "benefit" may be somewhat illusory. In any event, the corporate model is based upon the deferral principle and its benefits.
Allowing a shareholder to enjoy the benefits of the corporate model of taxation without bearing the burdens of the model is obviously inconsistent with protection of the dual entity, double tax system.

Most important, however, is the question of whether proper measurement of the shareholder's income requires relaxation of the rules protecting the integrity of the corporate tax model for losses as well as for income. A shareholder seeking recognition of loss may or may not receive consideration for the transfer of shares to the corporation. In a redemption, for example, the shareholder receives the fair market value of the shares, which, if less than their basis, creates a potentially recognizable loss. Adhering to the model for gains on redemptions, proper measurement of the shareholder's income from the transaction requires an inquiry into whether the corporation has distributed capital or income to the shareholder.

At first glance, stock surrenders appear to raise the same issues as loss redemptions in an even more extreme form since the taxpayer claims an ordinary, rather than capital, loss on the transaction. If allowed to claim losses on stock surrenders without limitation, taxpayers would have the benefits of future income deferral as well as the benefits of immediate recognition of losses attributable to a decline in the value of corporate assets. As a result, they would enjoy the benefits of the corporate model without its burdens. To prevent this, it is tempting to suggest limiting access to losses on stock surrenders based on the meaningful reduction standard so frequently used for exchange transactions.
However, the reasons for using this standard in the exchange context do not lead to a similar result in the stock surrender context.

For example, the *Fink* situation presents a partial absorption case. In that case, prior to the surrender, Peter Fink and his wife owned 52.2% and 20.3%, respectively, of the Travco stock. Other family members owned most of the remaining stock: Peter's sister owned 10.0%, his brother-in-law owned 4.1%, and his mother owned 2.2%. Thus, before the surrender, the Fink family owned, collectively, 88.8% of the Travco stock. After the surrender, the Fink family owned 87% of Travco. When no new investor appeared after the surrender, Peter and his wife and mother subscribed to the 700,000 new preferred shares. Thus, after subscription they continued to own 87% of the common and they acquired 100% of the preferred, which was convertible into 1,400,000 common shares, representing 51% of Travco. Upon conversion of the preferred, the Fink family would own 2,566,346 shares or 93.6% of Travco. When the surrender results in members of a family or economic unit retaining all or most of the interests in the corporation, deferral of recognition of loss seems appropriate under principles similar to those of section 267. As discussed above, see supra notes 128-32 and accompanying text, I.R.C. § 267 mandates non-recognition of losses until the benefits of property pass outside the members of the economic group.

Once the determination of the economic group is made, the inquiry must focus on the central issue of what constitutes evidence of exit from the corporate form in the stock surrender context. For example, the redemption rules focus on the reduction of the shareholder's interest in earnings, assets and voting power. Without a meaningful reduction in each, exchange treatment is denied. Are the redemption rules adequate in the stock surrender context, or do the peculiarities of stock surrenders require different rules? In the stock surrender context, the surrender of voting power is clearly the most important indicator of a meaningful change in the relationship between the shareholder and the corporation. If the surrendering shareholder remains in control of the corporation, directly or indirectly, it seems unlikely that a shift has really occurred in the relationship between the corporation and shareholder. Here it is important to distinguish the argument apparently made by the Finks in restructuring their corporation. Had the new investor appeared on the scene, control would have shifted, but no new investor acquired the shares. The tax consequences must, of course, follow what actually happened, not what was intended. For a shareholder without control prior to surrender, a determination must be made of the significance of the surrender from a practical point of view. For example, where several shareholders hold stock, the dominant shareholder surrendering a few shares, which do not themselves constitute control, might significantly change voting power.

The relative weight to be accorded the surrendering shareholder's interest in assets and earning power is unclear. The stock surrender generally takes place in a troubled company in which current dividend rights and interest in assets are less important than management rights. See supra notes 117-21 and accompanying text. As a result, focusing on these rights is of less importance in stock surrender cases than in redemption cases. Thus, in close cases, it may be appropriate to discount the value of a reduction in the shareholder's current interest in earnings and assets of a troubled corporation. Nevertheless, these rights are entitled to some attention, since the company may eventually recover sufficiently for the shareholder's interest in assets and dividends to have some value. After all, the shareholder surrenders the stock in order to protect these economic interests, not voting power alone.

Given these considerations, it appears that the redemption rules, or rules very similar to them, would suffice as a means of distinguishing shareholders who give up corporate form from those who do not. Thus, any meaningful reduction in shareholder's interest in voting power, earnings and assets would result in a transaction in which loss could be recognized; otherwise, the basis of the surrendered shares would be added to the basis of the remaining shares. In most cases, the result should be relatively clear. For example, neither the *Fink* nor the *Frantz* surrenders would qualify under this standard since in those cases the surrendering shareholders sought to claim the benefit of exit from the corporate form while sustaining the fundamental corporation/shareholder relationship. By contrast, a reduction in shareholdings from 80% to 40% should qualify,
Stock surrenders differ in one crucial respect from stock exchanges between a corporation and a shareholder. In a surrender, the shareholder receives no consideration for the shares, so no capital or income leaves corporate solution. Proper measurement of the positive income of the shareholder from the surrender transaction does not require a reckoning of just how much capital and just how much income has been distributed: nothing has been distributed that requires measurement or division as between income and capital. In the surrender context, therefore, the interest of fairly measuring the shareholder's income from the corporate investment need not force a compromise of the usual rule of deferral of capital recovery. Furthermore, allowing capital recovery in this context would allow the surrendering shareholder benefits of the corporate form, future income deferral, without bearing its burdens on the same capital investment. Subchapter C prevents this from occurring by forcing the taxpayer choosing the corporate model for capital investment to accept the consequences of that choice. As a result, a surrendering shareholder should not be allowed capital recovery, i.e., a loss, unless and until the surrender results in a complete termination of the shareholder's interest in the corporation.200

B. Tax Policy Implications

As noted above,201 Congress might have provided that capital recovery is never available in transactions between shareholders and corporations without complete termination of a shareholder's interest in the corporation by redemption, liquidation of the corporation, or worthlessness of stock. After all, while capital recovery may be required for proper taxation of income, Congress alone determines the appropriate

assuming the reduction was of shares representing a proportionate amount of voting power, interest in assets and interest in earnings. While this is the result reached by the Supreme Court, its reasoning offers little guidance as to why this is the proper result.

Finally, the familiar principle of examining a transaction for economic legitimacy is of particular importance in the stock surrender context because, as a practical matter, stock surrenders will generally be accomplished by controlling shareholders in closely held corporations. Although a taxpayer need not follow the most taxing path to a particular economic result, in the stock surrender context other methods of achieving the same results are often available. The presence of an equally feasible alternative not involving the surrender might suggest that the surrender was unnecessary except to reduce taxes, in which case the loss should be denied. For example, in the Fink case, a change in the conversion ratio for the new preferred shares could have resulted in a transfer of control to the new investor without the need for a stock surrender. None of the courts considering the case found this fact interesting as an indication of the bona fides of the Finks' surrender, yet focusing on such a fact might have suggested further inquiry into the economic reality of the reorganization plan.

200. This should probably be characterized as worthless stock.
201. See supra notes 174-92 and accompanying text.
time for capital recovery. But Congress provided no such rule, and instead allowed capital recovery at various times prior to liquidation. In the stock surrender context, the courts originally allowed a loss on surrender, and the Supreme Court, while disallowing a loss when the surrendered stock represented a small portion of the shareholder's interest, suggested that a meaningful shift might give rise to an ordinary loss.

What are the policy implications of allowing capital recovery in the stock surrender context? Since stock surrenders most often occur in faltering companies, allowing a deduction for capital recovery as a result of stock surrenders is best viewed as a subsidy to the controlling shareholders, perhaps to replace the income from the dividends they might otherwise receive from their ailing companies. This subsidy might best be justified as a means of maintaining troubled companies by supporting their shareholders until profitability returns. Keeping such companies afloat during the 1930's may well have been the unspoken rationale for the long line of Tax Court cases establishing the availability of the deduction for stock surrenders. Allowing a deduction in limited circumstances such as a meaningful shift in shareholder participation in the corporation could similarly be justified on the grounds that it encourages the transfer of corporate control to others in faltering companies while keeping corporate assets intact and operating.

But such a subsidy can be criticized on fairness grounds: shareholders of troubled companies who receive no dividends receive no deduction, while surrendering shareholders are allowed a deduction. The two categories of shareholders are similarly situated, except with respect to the unrealized appreciation or depreciation in their shares. Allowance of the subsidy undermines the fairness of the system by treating these shareholders differently. Similarly, the allowance of an ordinary loss for surrendering shareholders but a capital loss for shareholders who wait until their stock becomes worthless is indefensible since both groups are in precisely the same situation.

More fundamentally, it has not been proven that the subsidy works at all in encouraging the desired result. Furthermore, even if it does work, the use of tax subsidies may not be the most appropriate means of encouraging such behavior; other methods (i.e., direct transfer, bankruptcy laws, etc.) may be more effective and less expensive in producing the desired results. Courts today may be more willing to allow such companies to founder, or perhaps they at least hesitate to

use such problematic subsidies to prevent failure. In arguably more prosperous economic times, when crisis is limited to specific industrial sectors, general subsidies to the small businessperson may seem unnecessary. Perhaps sectors other than small business are the proper targets for subsidies. Subsidies in general, and tax subsidies in particular, may be suspect: the intended beneficiaries may not respond in the manner intended, the subsidies may be abused or may confer benefits upon unintended beneficiaries. Finally, federal budget deficits continue to remind even the judiciary that federal tax subsidies are hardly inexpensive. While it is impossible to know whether any or all of these concerns actually influenced the result in the modern stock surrender cases, these arguments for and against the availability of the deduction as a matter of tax policy should be considered.

Both fairness and the economic effects criticisms raise the question discussed by Justice Stevens in his dissent to the Fink decision: Which institution, Congress or the courts, should resolve such questions? 204 When the issue is limited to its doctrinal components the courts seem competent enough to reach the correct result, even if not through the correct reasoning. However, issues of tax law concern fundamental questions of revenue and expenditure—issues clearly within the Congressional prerogative. Entrusting such questions to the judiciary rather than Congress ensures further refinement of various doctrinal matters rather than the crucial analysis of the "how much?" "why?" and "who?" of federal budgeting.

IV. CONCLUSION

Stock surrenders, which occur primarily in closely held, troubled companies, raise fundamental questions regarding the timing of capital recovery attributable to a shareholder’s investment in the corporation. Trying to determine the proper tax consequences of stock surrenders by likening them to other, more familiar transactions may lead to the correct result, or at least a correct result, but will not provide a useful analysis, simply because stock surrenders do not share many of the characteristics of these other transactions. This Article has presented an arguably more informative approach to stock surrenders, beginning with the basic questions of loss recognition raised by the stock surrender, i.e., whether a surrendering shareholder realizes a loss upon surrender, and if so, whether the Code allows recognition of that loss. This Article has argued that a surrendering shareholder does

204. Id. at 101-06 (Stevens, J., dissenting).
indeed realize a recognizable loss, but that the fundamental principles of subchapter C should preclude recognition of that loss.

Throughout subchapter C, capital recovery is made dependent upon the shareholder’s choice to opt out of the corporate model with respect to a significant portion of the shareholder’s capital investment. This is justified by a need to protect the dual entity, double taxation system imposed by subchapter C in evaluating distributions and in preventing shareholders from opting for the benefits of the corporate form while avoiding its burdens. When in fact the shareholder has withdrawn corporate capital, accurate measurement of the shareholder’s income depends on an allowance for capital recovery, whether by a tax-free return of capital prior to determining gain or by recognition of loss. In the stock surrender context, however, protection of the double tax system while allowing proper income measurement is not an immediate concern since no distribution has been made to the shareholder. Allowing capital recovery upon surrender would allow the shareholder the benefits of the corporate model of taxation without its burdens, allowing future income deferral and current capital recovery for the same investment which remains in corporate solution. Essentially, since no capital has left corporate solution, an allowance for capital recovery for the shareholder is premature. Instead, the loss must be deferred until the shareholder either disposes of his entire interest in the corporation or disposes of a part of the shares in a transaction qualifying as a disposition giving rise to capital recovery.