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Commissioner v. Fink: The Final Judgment on Section 165(c)(2) Losses for Non Pro Rata Stock Surrenders

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NOTES

COMMISSIONER V. FINK: THE FINAL JUDGMENT ON SECTION 165(c)(2) LOSSES FOR NON PRO RATA STOCK SURRENDERS

As a result of the energy crisis in the early 1970s, Travco Corporation experienced a significant decline in the sale of motor homes and recreational vehicles. During 1973 and 1974 Travco suffered a major drop in earnings and a general weakening in its financial condition. Manufacturers National Bank of Detroit, which had extended to Travco a line of credit up to $3,400,000, expressed concern. To appease the bank's fears Mr. and Mrs. Fink, owners of 72.5% of Travco's stock, agreed to guarantee the corporation's debt up to $200,000.

By early 1976 the recreational vehicle market appeared disconcertingly bleak. Circumstances forced Travco to liquidate a major subsidiary that had buckled under the weight of its own $1,000,000 loan. Travco and its subsidiary compromised the debt with payments totalling $437,000. Motivated by the ominous demise of Travco's subsidiary, Manufacturers National exerted heavy pressure on the parent corporation for repayment of its debt. Travco's survival hinged upon finding a new bank, new capital, or both.

Toward the end of 1976, Travco managed to negotiate a deal with a new lender, the City National Bank of Detroit. The arrangement required Travco to obtain $900,000 in new capital—$700,000 of equity and $200,000 of subordinated debt. In order to attract the necessary outside capital, the Finks devised a strategy that would enable an investor to obtain control of the corporation by making the $700,000 equity investment. Pursuant to the plans, the Finks surrendered, without consideration, a total of 196,146

1. The taxpayers and five other investors acquired Travco, formerly Frank Motor Homes, Inc., in 1964. Travco served as a holding company for four operating subsidiaries that manufactured the motor homes and their component parts.
2. Travco in turn issued the Finks stock warrants for up to 200,000 shares at $1.00 per share.
3. In October 1973 Gemini Corporation, the liquidated subsidiary, had borrowed the funds from General Motor Corporation's Truck and Coach Division in order to build a manufacturing plant. Gemini furnished the interiors of motor homes that GMC manufactured. When GMC's Truck and Coach Division suspended production in 1976, Travco liquidated Gemini.
4. The plan also called for subordination of all existing shareholder debt.
shares of Travco stock.\(^5\)

Based on the non pro rata stock surrenders, the Finks reported a section 165(a) ordinary loss on their 1976 and 1977 joint income tax returns.\(^6\) Pursuant to Internal Revenue Code section 165(b), the Finks’ $389,039.25 cost basis in the stock determined the amount of the loss.\(^7\) The stock had an estimated market value of $9,807.30. Travco held the surrendered shares as treasury stock of zero value.

Travco ultimately failed to obtain the needed outside investment capital. Travco sold most of its assets and paid its creditors to the extent possible. The shareholders liquidated the corporation in 1980.

The Commissioner of the Internal Revenue Service disallowed the Finks’ loss deductions, asserting that the taxpayers had made a contribution to the capital of Travco. The Service argued that the taxpayers should reallocate the stock basis to their retained shares. Relying on a recent decision involving similar facts,\(^8\) the Tax Court, in an unpublished opinion, sustained the deficiency assessment. The Court of Appeals for the Sixth Circuit reversed the Second Circuit’s affirmation of that opinion.\(^9\) In order to resolve the conflict between the Sixth and Second Circuits, the United States Supreme Court granted certiorari. Held, reversed: A controlling shareholder’s voluntary non pro rata surrender of stock constitutes a contribution of capital to the corporation and does not generate recognition of loss. Commissioner v. Fink, 107 S. Ct. 2729, 97 L. Ed. 2d 74 (1987).

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5. Prior to his stock surrender, Mr. Fink owned 802,300 shares, or a 52.2% interest. The surrender reduced his holdings to 686,154 shares, a 51.2% interest in the outstanding stock. Mrs Fink’s holding declined from 311,359 shares (20.3%) to 231,359 shares (17.3%).

6. The Tax Court’s memorandum decision, Fink v. Commissioner, 48 T.C.M. (CCH) 786 (1984), does not specify an Internal Revenue Code section reference for the loss. The Sixth Circuit opinion, however, did refer to ordinary loss recognition under \(\text{\$165}\) of the Code. Fink v. Commissioner, 789 F.2d 427, 427 (6th Cir. 1986). I.R.C. \(\text{\$165}\) (West 1988) provides in part:

   (a) General Rule—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
   
   (b) Amount of Deduction—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.
   
   (c) Limitation on Losses of Individuals—In the case of an individual, the deduction under subsection (a) shall be limited to...
   
   (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business.

   Proportionate stock surrenders by all shareholders, as opposed to non pro rata surrenders, result in no loss recognition since the remaining shares absorb the value inherent in the surrendered stock. See Scoville v. Commissioner, 18 B.T.A. 261, 264 (1929) (citing Eisner v. Macomber, 252 U.S. 189 (1920)). In Eisner the court held that a tax on stock dividends was unconstitutional because a pro rata corporate distribution does not result in income to the shareholder. 252 U.S. at 211.

7. I.R.C. \(\text{\$165(b)}\) (West 1988). Section 165(b) refers to \(\text{\$1011}\) (adjusted basis for determining gain or loss), which in turn cross-references \(\text{\$1012}\) (basis of property shall be cost of such property, except as otherwise provided). \(\text{Id.} \) \(\text{\$\$1011, 1012}\) (1982).


I. HISTORICAL TREATMENT OF NON PRO RATA STOCK SURRENDERS

A. The Net Loss Approach

Two cases that the Board of Tax Appeals decided in 1941 provided a precedent for loss recognition based on shareholders' non pro rata stock surrenders to their corporations. In Miller v. Commissioner the financial problems of the Grossman Shoe Company motivated a voluntary stock surrender. Specifically, the taxpayer surrendered 200 out of 500 shares of stock owned and claimed a $20,000 loss, the amount of his tax basis in the stock. The Board of Tax Appeals approved the loss, but only to the extent that it exceeded the increase in value to the taxpayer's remaining shares. The

10. Several cases predate the Internal Revenue Code of 1939. In this earlier litigation, the taxpayers, the Commissioner, and the courts experimented with the application of various provisions of the Revenue Act of 1921, ch. 136, 42 Stat. 227 (1921 Act). In Ames v. Commissioner, 14 B.T.A. 1067, 1072 (1929), aff'd, 49 F.2d 853 (8th Cir. 1931), the Board of Tax Appeals disallowed the shareholder's deduction for stock surrendered to corporate employees who had achieved a predetermined profit record for a corporate publishing company. The taxpayer argued for the deduction as an ordinary and necessary business expense under § 214(a)(1) of the 1921 Act. The court rejected this view on the grounds that the taxpayer was not in the publishing business. Id.; see Hewett v. Commissioner, 47 T.C. 483, 487-90 (1967) (deduction for stock transferred as sales commission denied under both I.R.C. § 162 (1954), business expense, and id. § 212, nonbusiness expense incurred for the production of income); Fischer v. United States, 336 F. Supp. 428, 431-32 (E.D. Wis. 1971), aff'd, 490 F.2d 218 (7th Cir. 1973) (shareholder denied deduction under same provisions for bargain sale of stock to parties threatening litigation). In Wright v. Commissioner, 18 B.T.A. 471, 472-73 (1929), modified, 47 F.2d 871 (7th Cir. 1931), the Board of Tax Appeals allowed a cost-based loss to a taxpayer whose creditors had in essence forced the surrender of 51% of his holdings and used the stock to compensate a new manager that the creditors had selected. The Commissioner had argued that §§ 202(a) and (b) of the 1921 Act required the stockholder to allocate the cost to his remaining shares. Justice Murdock, in dissent, agreed with the Commissioner, insisting that the tax treatment should be the same for contribution of stock or cash. 18 B.T.A. at 473. The Seventh Circuit held that instead of using the stock's cost, the taxpayer should use the value of the stock at the time of the surrender in order to determine the loss. 47 F.2d at 872. Similar to Wright, the taxpayer in Burdick v. Commissioner, 20 B.T.A. 742 (1930), aff'd, 59 F.2d 395 (3d Cir. 1932), claimed a loss under § 214(a)(5) of the 1921 Act for indirect stock transfers to third parties. The Board of Tax Appeals allowed the deduction under this provision, which bears close resemblance to I.R.C. § 165(c)(2) (West 1988), and rejected the Commissioner's attempt to characterize the transaction as a reorganization under § 202(c)(2) of the 1921 Act. 20 B.T.A. at 747-49; cf. Ward v. Commissioner, 18 B.T.A. 326, 328 (1929) (loss that bank director claimed for pro rata cash contribution to cover bad loans disallowed due to lack of profit intent).

Litigation continued under the Revenue Act of 1924, ch. 234, 43 Stat. 253 (1924 Act). See City Builders Fin. Co. v. Commissioner, 21 B.T.A. 800, 803-04 (1930) (corporation's stock surrender as litigation strategy treated as sale or disposition of property, so that loss equaled stock cost under § 204(a) of 1924 Act); Vaughan v. Commissioner, 15 B.T.A. 596, 600, aff'd on rehearing, 17 B.T.A. 620 (1929) (bank president allowed partial loss under net loss provision, § 206(a) of 1924 Act, for securities transferred to cover misappropriation).


12. 45 B.T.A. at 297. Problems in computing the appropriate amount of loss in stock surrender cases persisted from the cases in the 1920s through the Supreme Court's analysis in Fink. The Court of Claims in Peabody Coal Co. v. United States, 8 F. Supp. 845 (Ct. Cl. 1934), rejected the Seventh Circuit's holding in Wright that the basis for determining the loss should be the fair market value of the stock on the date of the surrender. Id. at 848; see Wright, 47 F.2d at 872. The Peabody court computed the loss based on the cost of the stock relinquished and ignored the speculative impact on the value of the stock retained. 8 F. Supp. at 849; see Plumley v. Commissioner, 29 T.C.M. (CCH) 98, 101 (1970) (no loss on shares
court held that the increase in value amounted to $10,178, thereby reducing the allowable loss to $9,822. The Board concluded that the taxpayer should have added the $10,178 disallowed loss to the cost basis of his remaining shares, with recovery of the investment postponed until the future sale or other disposition of the stock.

_Budd International Corp. v. Commissioner_ involved a number of transactions relating to the reorganization and refinancing of an international conglomerate. As an inducement for the participants to approve a particular phase of the plan, the corporation surrendered shares that it held in Ambi-Budd Presswerk, a German corporation. The corporation's shares had a cost basis of $86,704.54. Although the Service acknowledged that the taxpayer sustained a loss, the Service attempted to categorize it as a capital loss subject to the $2,000 limitation of section 117(d) of the Revenue Act of 1936. Noting that the issue was merely one of amount, rather than deductibility in general, the Board stated that defining the transaction as a sale or exchange would reflect an obvious inconsistency since the stockholder received no money, property, or other rights for the surrendered stock. The Board held that the loss was fully deductible.

In _Estate of Foster v. Commissioner_ the Tax Court addressed an issue related to the situation in _Miller_. In an effort to improve the financial

transferred in consideration for services performed as the fair market value was equal to adjusted basis of stock; Sack v. Commissioner, 33 T.C. 805, 808 (1960) (loss on transfer of stock to induce two parties to assume management disallowed due to lack of proof of contract's value); Clement v. Commissioner, 30 B.T.A. 757, 762-63 (1934) (purported sale of $100 cost basis stock for one cent recharacterized as capital contribution when value of stock was not ascertainable from evidence).

13. 45 B.T.A. at 299.
14. Id.
16. Revenue Act of 1936, ch. 690, 49 Stat. 1692. Capital loss treatment, particularly in transfers to third parties, remained an open issue in subsequent cases. See Fred H. Lenway & Co. v. Commissioner, 69 T.C. 620, 627-28 (1978), aff'd, 620 F.2d 310 (9th Cir. 1980) (stock surrender held as part of later fulfillment of warranty obligation, and court treated combined transaction as capital loss); Granata v. Commissioner, 22 T.C.M. (CCH) 1627, 1634 (1963) (taxpayer sustained capital loss on transfer of stock to third party for indemnity agreement with no fair market value).
17. 45 B.T.A. at 756.
18. Id.
19. 9 T.C. 930 (1947).
20. Both _Foster_ and _Miller_ dealt with voluntary non pro rata stock surrenders, but Foster's transaction amounted to a compensatory transfer to a third party, while Miller sought to negate the effect of substantial operating losses that his corporation had suffered. The cases represent two distinct trends in stock surrender litigation; compensation versus corporate survival. _Fink_'s objective focused on the latter. The two scenarios are important from a historical perspective since the Tax Court utilized both fact situations in its analysis of subsequent cases. See generally _O'Brien_, _Stock Transfers by Shareholders to Outsiders for Nontangible Consideration_, 39 _Taxes_ 675, 679-81 (1961) (explanation of shareholder loss computation on stock transfers to third parties based on pre-1969 case law). Compensatory transfers, however, generally fell under statutory control with the Tax Reform Act of 1969, Pub. L. No. 91-172, § 321, 83 Stat. 487, 588-91, which added § 83 to the Internal Revenue Code. Section 83 still left many questions unanswered since it focused more on the consequences to the corporate employer and employee than to shareholders. _I.R.C. §§ 83(a), (h) (West 1988); see Wagner,
condition of his corporation, Foster Machine Company, Foster donated stock to the corporation. A third party, Carl D. Greenleaf, bought some of this stock through a prearranged plan. The dispute in Foster focused not on determining the amount of the taxpayer's recognizable loss from stock that he surrendered, but rather on assessing the impact on the stock that he retained. Foster ultimately sold the unsurrendered stock. The executor of Foster's estate argued that the amounts Greenleaf paid to the corporation should be part of the basis of the stock sold. The court rejected this view and held for the Commissioner. Despite the apparent victory for the Service, the Tax Court calculated the retained shares' basis using the same principle that Miller applied.

In Downer v. Commissioner the Tax Court provided an original analysis of the tax status of stock voluntarily returned to the taxpayer's corporation. The facts of the case resembled Foster in that a third party ultimately obtained the stock. In Downer, however, the taxpayer contributed 100,000 shares to the trustee of an escrow account. Downer then instructed the trustee to distribute the stock free of charge to the corporation's vice president in the hopes of retaining his services. The opinion focused on whether a loss was recognizable in these circumstances, since a cash contribution

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2.  21. 9 T.C. at 936-37.

22.  *Id.* at 937. The factual complexity of Foster may have contributed to the divergent interpretations of the case in later years. Between 1922 and 1935, Foster transferred 2,180 shares of common stock to Greenleaf, for which Greenleaf paid Foster Machine Company $218,000. Foster also donated 1,848 shares of preferred stock to the corporation. Greenleaf purchased 800 of these shares from the company, while the corporation retired and cancelled the other 1,048 shares. Foster did not reflect any of these transactions on his personal income tax returns. In 1940, Foster sold his 2,059.5 remaining shares of common stock for $205,950. Foster's estate claimed that the basis in the stock sold should consist of Greenleaf's payments to the corporation of $218,000 and $80,000 plus Foster's $46,793.20 basis in the 1,048 shares surrendered and cancelled. The court rejected the estate's novel approach.  *Id.* at 936-37. Instead, the court held that the basis consisted of: $24,197.50 original cost, $8,303.04 cash contribution made in 1938, $10,900 basis of the stock sold to Greenleaf, plus $76,119.12, the court's determination of the increase in value to Foster's common stock that resulted from the surrender of Foster's preferred shares.  *Id.* at 937-38. Thus, under the court's analysis the amount of Foster's loss on the preferred stock surrender would have been his cost basis of $184,000, less the $76,119.12 appreciation to the remaining stock or $107,880.88; but, by merely discussing basis the court was only indirectly addressing the loss issue.  *Id.* at 930.

23.  48 T.C. 86 (1967).
would have had no immediate tax consequences.\textsuperscript{24} The court asserted that taxpayers should view stock ownership on a share-by-share or fragmented basis rather than as part of one, undivided proprietary interest.\textsuperscript{25} Applying the fragmentation theory, the court allowed a loss based on the proportionate ownership in the stock surrendered.\textsuperscript{26} Cash contributions, the court noted, do not have the same effect as stock surrenders since cash contributions do not change the shareowner’s ownership interest in the corporation.\textsuperscript{27}

The \textit{Downer} court, thus, clearly spelled out the theory behind the overall debate. The fractional or fragmentation doctrine focuses on the idea that each share of stock creates an intangible asset representing ownership rights.\textsuperscript{28} Accordingly, the forgone rights serve as the basis for loss recognition upon disposition of the stock.\textsuperscript{29} When an investor contributes a fungible commodity such as cash, the capital structure absorbs it without altering individual ownership rights.\textsuperscript{30} When a shareholder contributes stock, however, the ownership rights remain attached, decreasing the contributor's rights and increasing the proportional ownership of the other shareholders.\textsuperscript{31} The \textit{Downer} court concluded that the proper characterization of the loss fell under capital loss treatment since the transaction amounted to an indirect payment of compensation rather than a true surrender of ownership interest.\textsuperscript{32} Finally, the court refused Downer’s argument that the ultimate transfer to the vice president stemmed from “spontaneous unilateral impulse.”\textsuperscript{33}

\textbf{B. Fifth Circuit Redefines Foster}

\textit{Smith v. Commissioner}\textsuperscript{34} represents the first appellate level decision to dispute the Tax Court’s policy of permitting loss recognition for stock surrenders. In \textit{Smith} the Tax Court applied the same analysis that it had used in

\begin{itemize}
  \item 24. \textit{Id.} at 90. Since the mid 1930s the courts have recognized losses on bargain sales of stock to corporate employees as allowable deductions. \textit{See, e.g., Scherman v. Helvering, 74 F.2d 742, 743 (2d Cir. 1935) (shareholder allowed loss on below market value stock sale to induce employee to remain with company); Brener v. United States, 282 F.2d 720, 727 (Ct. Cl. 1960) (same fact situation, citing \textit{Scherman} as controlling); Kress v. Stanton, 98 F. Supp. 470, 476-77 (W.D. Pa. 1951), aff’d \textit{per curiam}, 196 F.2d 499 (3d Cir. 1952) (estate executors allowed loss on bargain stock sale to company vice president based on profit motive of future dividends).}
  \item 25. 48 T.C. at 91. The fragmentation or fractional theory contrasts with the unitary view that sees the taxpayer's holdings in the corporation as one investment irrespective of the individual shares. \textit{See Note, Frantz or Fink: Unitary or Fractional View for Non-Prorata Stock Surrenders, 48 U. Pitt. L. Rev. 905, 913 (1987).}
  \item 26. 48 T.C. at 91-92.
  \item 27. \textit{Id.} at 90-91.
  \item 28. \textit{See Note, supra note 25, at 907-08.}
  \item 29. \textit{Id.} at 920.
  \item 30. \textit{See Bolding, Non-Pro Rata Stock Surrenders: Capital Contribution, Capital Loss or Ordinary Loss?, 32 Tax L.A.W. 275, 277 (1979).}
  \item 31. \textit{Id.} at 277-78.
  \item 32. 48 T.C. at 93.
  \item 33. \textit{Id.}
  \item 34. 66 T.C. 622 (1976), \textit{rev'd sub nom.} Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979). Ronald E. Schleppy and David N. Smith capitalized the corporation involved with contributions of $120,000 and $80,000, respectively.}
\end{itemize}
Foster and Downer. Specifically, the court permitted an ordinary loss to Ronald Schleppy and David Smith for their voluntary surrender of stock to Communications and Studies, Inc. (C & S). The taxpayers had previously borrowed funds from Shareholders Associates, Inc. (Associates) under the condition that they would get Associates' approval before exchanging more than a total of 50,000 shares of C & S stock. As a result of their participation in expansion transactions over time, the taxpayers realized that they might have violated the terms of their loan, thus giving Associates the right to convert their notes into shares pursuant to the agreement. Aware of their potential liability for mismanagement if Associates exercised its option, the taxpayers surrendered a sufficient number of shares to offset the impact of the notes' conversion. The Tax Court noted that any increase in the value of Schleppy's and Smith's remaining stock was minor. Accordingly, the court permitted a loss equal to their total basis in the surrendered stock.

In a strongly criticized opinion, the Fifth Circuit, in the retitled case of Schleppy v. Commissioner, reversed Smith, holding that the taxpayers had no recognizable loss. The court cited Foster as the precedent for this holding, a view that generated considerable controversy. The basis of conflict could be a question of application, rather than interpretation. Foster continued to reflect the same formula for loss recognition that Miller had used. Conceptually, the computation required a four-step analysis: (1) determine the cost basis of the stock surrendered; (2) subtract the increase in value to the taxpayer's remaining shares resulting from the stock surrendered; (3) allow the net excess as ordinary loss; and (4) reallocate to the remaining shares the portion of stock basis not recognized as ordinary loss. In the Fifth Circuit's view, the amount of the market value increase equaled the cost basis of the stock, so that no excess remained to recognize as a loss. As a result, the court reallocated the entire basis to the remaining shares. Although the Tax Court saw the effect on the remaining shares as minimal, the Fifth Circuit determined the impact to be substantial enough to eradicate the entire loss.
C. Tax Court Denies Section 165(c) Loss

In the 1984 case of *Frantz v. Commissioner*47 the Tax Court abandoned its long-held position on loss recognition for stock surrendered.48 *Frantz* involved a typical stock surrender in which the investor attempted to sustain the corporate business activity through a variety of finance mechanisms, including the voluntary relinquishment of all his preferred stock. The taxpayer in *Frantz* retained his sixty-five percent ownership of the corporation’s common stock for an additional six months, at which time he sold the stock. The Tax Court’s primary motive for changing its position arose from its inability to fit the transaction within the provisions of section 165(c) of the Code, which tie loss deductions to transactions entered into for profit.49 The court reasoned that loss avoidance, rather than a profit incentive, motivated the transaction.50 The ordinary loss permitted under section 165(c) also seemed to conflict with the capital loss treatment that the worthless securities provision of section 165(g) required.51 Supported by this statutory analysis, the court proclaimed its past errors and ruled that instead of generating an ordinary loss, the taxpayer should allocate the basis of the surrendered stock to the retained shares.52

Based on a detailed review of the stock surrender issue, the Second Circuit warily affirmed the Tax Court’s decision.53 The appellate court discussed the relative merits of the fragmented view versus the unified view, a principle that the Tax Court in *Downer* had originated.54 The Second Circuit noted the dilemma in refusing to permit a deduction when the shareholder immediately loses all rights associated with ownership upon the surrender of the stock.55 As a counter-argument to loss recognition, the court examined section 263(a) of the Code, which disallows deductions for property improvements until the taxpayer disposes of the property.56 The court acknowledged that each approach may create practical and jurisprudential

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48. 83 T.C. at 174. The court stated “the time has come to reassess our position and to confess error if necessary.” *Id.*
49. *Id.* at 181; see I.R.C. § 165(c) (West 1988).
50. 83 T.C. at 181.
51. *Id.* at 182. Section 165(g)(1) of the Code treats worthless securities as capital assets sold on the last day of the tax year. I.R.C. § 165(g)(1) (West 1988).
52. 83 T.C. at 181.
54. 784 F.2d at 123-25. For a discussion of *Downer*, see supra notes 23-33 and accompanying text.
55. 784 F.2d at 124.
56. *Id.* I.R.C. § 263(a) (West Supp. 1988) states:
   General rule—No deduction shall be allowed for—
   (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.
   (2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

The remaining subsections under § 263 deal with advertising and goodwill, intangible drilling
difficulties, but the court failed to provide an original theory to resolve the controversy. It, instead, unequivocally rejected application of the capital loss rules on the basis that treating a unilateral stock surrender as a sale or exchange would conflict with the ordinary meaning of a sale or exchange. Furthermore, the court failed to analyze the inapplicability of section 165(c)(2), which was the key factor in the Tax Court's decision. Making reference to the Schleppy holding, the Second Circuit essentially based its affirmation on the fact that the surrender did not substantially reduce the taxpayer's equity in the corporation because of the offsetting increase in value to the taxpayer's remaining shares. The court expressed a substantial reservation in its conclusion, stating that its holding does not necessarily apply to more substantial stock surrenders that could generate immediate loss recognition.

II. COMMISSIONER V. FINK

A. Contribution to Capital

In an attempt to reconcile the circuit court holdings in Frantz and Fink, the Supreme Court in Fink outlined some general observations regarding the nature of capital contributions. The Court cited section 263 of the Code and the regulations thereunder in support of the proposition that voluntary contributions typically generate no immediate tax consequences. Section 263, however, primarily distinguishes between property improvements and operating expenditures. Specifically, while taxpayers can only recover capital investments for new buildings and permanent improvements on a long-term basis through depreciation, they may currently expense operating costs. Section 1.263(a)-2(f) of the regulations ultimately refers to section and development costs, railroad ties and rolling stock, interest and carrying charges on straddles, and payments in lieu of dividends in connection with short sales. Id. § 263.

57. 784 F.2d at 124.
58. Id. at 124-25.
59. Frantz v. Commissioner, 83 T.C. 162, 181 (1984). The Tax Court had concluded that the taxpayer was attempting to decrease or avoid a loss rather than enter into a transaction for profit. Id.
60. 784 F.2d at 125 (citing Schleppy v. Commissioner, 601 F.2d 196, 199 (5th Cir. 1979)). The taxpayer's ability to manipulate the transaction for maximum tax benefits by surrendering stock before it becomes worthless, or sell it at a loss, also influenced the court. Id.
61. Id. at 126. In so holding, the court apparently did not reject the underlying concept of loss recognition for voluntary non pro rata stock surrenders.
62. 107 S. Ct. at 2732, 97 L. Ed. 2d at 81-82.
65. 107 S. Ct. at 2732, 97 L. Ed. 2d at 81-82.
68. Id. §§ 162 (trade or business expenses), 212 (expenses for production of income). See generally Kilbourn, Deductible Expenses: Transactions Entered into for Profit; Income Producing Property, 21 N.Y.U. INST. ON FED. TAX. 193 (1963) (examination of application and relative breadth of I.R.C. §§ 165(c)(2), 212).
which stipulates that voluntary pro rata contributions from shareholders do not constitute corporate income.\(^7\) From the investor's perspective, regulation section 1.118-1 states that such contributions represent an additional price paid for the shares that the taxpayer holds.\(^7\) The regulations under section 118 and section 263, therefore, provide only a very general overview of the statutory treatment of contributions to capital.\(^7\) Neither section makes any specific reference to stock contributions, pro rata or non pro rata. Instead, the provisions emphasize postponing tax benefits by allocating costs to existing assets in favor of permitting current deductions.\(^7\)

The other major focal point of the Court's preliminary analysis dealt with the release of corporate debt by shareholders. The Court cited section 1.61-12(a) of the regulations,\(^7\) which states that a shareholder's gratuitous forgiveness of corporate debt constitutes a contribution to capital.\(^7\) In addition to the debt-forgiveness provision, the Court cited three cases that illustrate that a shareholder may not claim an immediate loss for outlays made to benefit the corporation.\(^7\) None of these cases, however, specifically dealt with stock surrenders or forgiveness of corporate debt by a shareholder. On the basis of this background, the Court proceeded to resolve the question of whether stock contributions warrant the same treatment as cash contributions, made either in the form of direct payments or by forgiveness of debt.

**B. Stock Surrenders as Capital Contributions**

Without citing any specific case law or statute, the Court concluded that stock surrenders are similar to a surrender of debt by a shareholder.\(^7\) The only supporting reference came from a major treatise on federal corporate

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\(^70\) Treas. Reg. 1.118-1 (1960) states that if a corporation obtains funds through voluntary pro rata payments by its shareholders and credits the funds to its surplus account, then the payments are not income, even though the outstanding shares of corporate stock remain unchanged. The regulation treats the payments as an additional price paid for the stock that the individual shareholders held and thus constitutes part of the corporate operating capital. *Id.*

\(^71\) *Id.*


\(^73\) I.R.C. §§ 118 (West 1988), 263 (West Supp. 1988); see *Research Institute of America, supra* note 72, ¶¶ L1601, F4800.

\(^74\) Treas. Reg. § 1.61-12(a) (as amended in 1980).

\(^75\) 107 S. Ct. at 2732, 97 L. Ed. 2d at 82.

\(^76\) *Id.* The Court cited Deputy v. Du Pont, 308 U.S. 488, 497 (1940) (costs incurred by beneficial shareholder to provide corporate executives equity interest in company not deductible); Sackstein v. Commissioner, 14 T.C. 566, 569 (1950) (partnership's payments to cooperative corporate suppliers treated as contributions to capital, not operating expenses); Eskimo Pie Corp. v. Commissioner, 4 T.C. 669, 676-77 (1945), *aff'd*, 153 F.2d 301 (3d Cir. 1946) (interest and royalties paid on behalf of subsidiary nondeductible).

\(^77\) 107 S. Ct. at 2733, 97 L. Ed. 2d at 83.
The Court provided a quotation from this source that emphasized that voluntary contributions generate no gain or loss for the shareholder. The authors' discussion, however, focuses on pro rata capital contributions, which the Court has long recognized as tax neutral events. Although the Court acknowledged that, unlike cash or cash equivalent contributions to capital, a stock surrender reduces the shareholder's proportionate interest in the corporation, it simply stated that not every change in ownership has immediate tax consequences. Nevertheless, the Court failed to provide an illustration of its aphorism.

The Court's next argument pointed to the lack of a reliable method for evaluating the amount of actual economic loss that a stock surrender generates. According to the Court, it must take into account the impact on the investor's remaining shares. Such an analysis requires a determination of open market values. Implicitly, the Court adopted a unitary rather than a fragmentary concept for the treatment of stock surrenders. Analyzed from a fragmentary perspective, each share of stock has a specific tax basis, which its cost generally determines. When the stockholder surrenders that share for no consideration, his or her stock's tax basis determines the loss. The impact on the remaining shares' value merits little, if any, attention. A reasonable analogy might be the discarding of over-stocked or out-dated inventory for the purpose of improving the general marketability of remaining goods. The cost of the abandoned goods would qualify as an allowable loss under section 165(c)(1) of the Code. Although in this instance the loss is business related, the concept reflects an accepted application of the fragmentary approach.

Section 1.165-1(b) of the regulations served as the statutory reference for
the Court's disallowance of the Finks' loss. This regulation, however, requires only that the loss is: (1) evidenced by a closed and completed transaction; (2) fixed by an identifiable event; and (3) actually sustained during the tax year. Once again, the Finks' stock surrender satisfied these three criteria from the fragmentary view.

The Court's final basis for disallowing loss recognition on the surrender of stock centered on the inequity of permitting an ordinary loss under sections 165(a) and (c)(2) of the Code, while requiring capital loss treatment for worthless stock under section 165(g)(1). Although the Tax Reform Act of 1986 substantially revised the treatment of capital gains and losses, a $3,000 net capital loss limitation still applies to noncorporate taxpayers. The Court noted that the preferential treatment afforded stock surrenders provides a strong incentive for investors in a failing corporation simply to surrender their stock before it becomes worthless. The Court acknowledged, however, that section 1211 of the Code restricts capital losses to sales or exchanges of capital assets and that a voluntary surrender without consideration fails to satisfy this definition. Surprisingly, the Court stated that the requirement for reallocating the surrendered stock's basis to the remaining shares is not inconsistent with section 1001(a) of the Code. Section 1001 deals with gains and losses on property, but speaks in terms of a sale or other disposition. Arguably, one could categorize the loss from stock surrendered as simply the disposition of an asset. Applying the language of section 1001, the statute defines loss in terms of the excess of the adjusted basis of the property over the amount of cash or property received. In a stock surrender situation, therefore, the entire stock basis would determine the loss since the shareholder receives nothing upon the stock's disposition.

The court cited two other pertinent Code sections in its final footnotes. The policy reasons behind section 302, which determines whether a stock redemption actually constitutes a dividend, appeared to influence the Court's decision. Section 302 focuses on preventing controlling shareholders from converting ordinary income dividends into capital gain stock exp-

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92. 107 S. Ct. at 2734, 97 L. Ed. 2d at 84.
94. The fragmentary view, by definition, assumes a closed transaction. See Note, supra note 25, at 918.
95. I.R.C. §§ 165(a), (c)(2) (West 1988).
96. 107 S. Ct. at 2734, 97 L. Ed. 2d at 84; see supra note 51 (summary of text of I.R.C. § 165(g)(1) (West 1988)).
98. 107 S. Ct. at 2734, 97 L. Ed. 2d at 84.
100. 107 S. Ct. at 2734 n.13, 97 L. Ed. 2d at 84 n.13.
101. Id. at 2735, 97 L. Ed. 2d at 85.
102. I.R.C. § 1001(a) (1982). Section 1001(a) states, by cross reference to § 1011, that the adjusted basis for determining gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis as determined under § 1012. Id.
103. Id.
104. Id. § 302.
To qualify for the latter, historically more beneficial, tax treatment essentially requires reducing one's holdings to below fifty percent ownership. Noting that the Finks remained dominant shareholders after their stock surrender, the Court stated that the *Fink* case did not require the Court to decide whether it should not allow loss recognition to shareholders who give up corporate control. As another illustration of congressional support for its holding, the Court referred to section 83 of the Code. Section 83, however, basically involves restricted stock options and other property transferred in connection with the performance of services. The provision applies to three-sided transactions such as those disputed in *Downer*, but does not apply directly to stock surrenders that financial restructuring has motivated, as in *Fink*. As the Court pointed out, however, both compensatory plans for corporate officers and stock surrenders pursuant to financing arrangements ultimately serve to increase the value of the shareholders' retained equity. Section 83, therefore, provides at least a weak analytical link between the Code and the Court's decision in *Fink*.

C. The Dissenting Opinion

Justice Stevens, in a lengthy dissent, asserted that although the majority's analysis held merit, the Board of Tax Appeals resolved the issue in 1941. Justice Stevens specifically cited *Herman & MacLean v. Huddleston*, in which the Court declared that any rule of statutory construction consistently recognized for more than thirty-five years simply puts the issue beyond un-

106. See 3 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 21.03 (1985) (taxpayers may attempt stock redemptions with purpose of obtaining capital gain treatment for property withdrawn, but Code may nevertheless treat such distributions as essentially equivalent to dividend).


108. 107 S. Ct. at 2735 n.15, 97 L. Ed. 2d at 85 n.15.

109. Id. at 2734-35 nn.14 & 15, 97 L. Ed. 2d at 84-85 nn.14 & 15. I.R.C. § 83(a) (West 1988) provides that if property is transferred to another person for services performed, then the recipient of the property must include in income the fair market value of the property in excess of any amount paid for the property. The year of inclusion is determined by the point in time at which the property is no longer subject to a substantial risk of forfeiture. *Id.* Section 83(h) allows a deduction under *id.* § 162 to the transferor that corresponds with the year of inclusion in the recipient's income. *Id.* § 83(h). Regulation § 1.83-6(d) states, however, that the transaction constitutes a contribution of capital to the corporation by the shareholder, with the company entitled to the corresponding deduction. Treas. Reg. § 1.83-6(d) (1978).

110. See supra note 109 and accompanying text.

111. 107 S. Ct. at 2734 n.14, 97 L. Ed. 2d at 84 n.14.

112. Id. at 2736, 97 L. Ed. 2d at 86 (Stevens, J., dissenting).

113. See supra note 109 and accompanying text.

certainty. Unless a past error was blatant to the point of overcoming the presumption of judicial adherence to statutory interpretation, the Court should remain consistent. The dissent emphasized, however, that the majority failed to establish any error on statutory grounds.

To allow the Commissioner to acquiesce in early decisions and then retract the acquiescence after the Finks had completed their stock surrenders seemed, in Justice Stevens's view, particularly unwarranted. Identifying the repeated affirmations of the Tax Court in stock surrender cases, Justice Stevens maintained that fairness to the individual taxpayer mandated that the Court remain consistent.

The dissent observed that a policy of retroactive application of the Court's holding undermines the reliability of court decisions and reflects unwise judicial administration.

The final important issue that Justice Stevens raised focused on the role of Congress versus the Court. The concept of loss recognition for non pro rata voluntary stock surrenders predated the major Code revisions of 1954 and 1986. Accordingly, Congress had ample opportunity to correct the judicial interpretation of the Code if it believed an error existed. Considering the extensive tax legislation enacted over the last fifty years, Congress's omission of any provision to classify a stock surrender as a contribution to capital or to structure the disposition as a capital loss reasonably implied that Congress sanctioned the prior tax treatment of ordinary loss recognition.

III. CONCLUSION

The Supreme Court in Commissioner v. Fink ended a half century of section 165(c)(2) ordinary loss treatment for voluntary, non pro rata, stock surrenders by dominant shareholders to their corporations. With the exception of some stock surrenders that the courts had recast as payments to third parties, the courts had consistently permitted loss recognition for over forty years. In 1979 the Fifth Circuit in Schleppy altered the course by rejecting the Tax Court's computational result, although it allowed the underlying principle to remain intact. Historically the courts had calculated stock surrender losses by subtracting the increase in value of the remaining shares from the surrendered stock's cost basis and permitting the net difference as a loss. The Fifth Circuit in Schleppy held that the increase in value exceeded the cost basis, eliminating the loss. The computation, however, still presumed use of the fragmentation theory, which views stockholder rights attaching to the individual shares along with the stock's cost basis.

115. Id. at 380.
116. 107 S. Ct. at 2737, 97 L. Ed. 2d at 87 (Stevens, J., dissenting) (citing Square D Co. v. Niagara Frontier Tariff Bureau, 106 S. Ct. 1922, 1930, 90 L. Ed. 2d 413, 426 (1986)).
117. Id.
118. Id. at 2738, 97 L. Ed. 2d at 89.
119. Id. at 2736-38, 97 L. Ed. 2d at 86-89.
120. Id. at 2738, 97 L. Ed. 2d at 89.
121. For a description of stock surrender cases predating the 1939 Internal Revenue Code, see supra note 10.
122. 107 S. Ct. at 2737, 97 L. Ed. 2d at 88.
In 1983 the Sixth Circuit weakened the fragmentation concept by holding that section 83 prohibits loss recognition for compensatory indirect stock transfers. The Tax Court yielded to the appellate level pressure in 1984 by simultaneously denying stock surrender losses in the cases of *Frantz* and *Fink*. Despite its previous section 83 loss denial, the Sixth Circuit reversed *Fink*. In contrast, the Second Circuit affirmed *Frantz*. To resolve the conflict between the circuits, the Supreme Court granted certiorari to *Fink*, ultimately reversing the Sixth Circuit and disallowing the taxpayers' loss recognition.

In consideration of *Fink*, the Supreme Court adopted the unitary approach, which reallocates the cost basis of surrendered stock to the investor's remaining shares, postponing loss recognition until the disposal of the controlling interest. The Court cited prior case law that had established the principle of disallowing individuals' deductions for costs incurred to benefit their corporations. Stock surrenders, however, concern the disposition of a specific asset, the cost of which the corporate balance sheet already reflects. To characterize the stock surrender as a contribution to capital contradicts the meaning of the phrase. The shareholder forfeits ownership rights, but the corporation receives no additional capital. The Court attempted to draw support for its holding from section 263 of the Code. Section 263, however, basically differentiates between current expenses and capitalized costs, with the latter typically recovered through depreciation. Traditionally, the Code distinguishes between expenditures and losses since expenses involve cash outlays, while losses focus on the disposition of an asset with a unique cost basis. The Court also cited section 165(g), which treats worthless stock as a capital loss, arguing that shareholders should not have the advantage of ordinary loss treatment through stock surrenders. Deferring loss recognition indefinitely, however, seems just as inconsistent with section 165(g) as permitting an immediate ordinary loss. Overall, the Court's strained statutory references provided minimal support for its analysis and ignored the fact that during the course of forty years of tax legislation Congress has consistently abstained from denying ordinary loss recognition for stock surrenders.

*Dwight Robert Shockney*