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## VI

### BASIS PROBLEMS AFFECTED BY FAIR MARKET VALUE

Howard M. Kohn

The general rule for determining the basis of property is that the basis is cost.<sup>1</sup> There are, however, a number of ways in which property may be acquired other than by purchase. In some of those cases, and even in certain purchase situations, it may be necessary to determine the fair market value of property as of a certain time in order to ascertain the basis.

#### PRE-1913 PROPERTY

One of the oldest exceptions to the general rule that basis is cost relates to property acquired before March 1, 1913. In the case of such property, for the purpose of determining gain, the basis as of March 1, 1913, will be either the basis determined under the applicable rules or the fair market value on March 1, 1913, whichever is greater.<sup>2</sup> The law relating to the basis of property acquired before March 1, 1913, obviously is not so important now as it once was. Many of the principles for determining fair market value, however, were developed in cases involving valuation of property as of that date.

#### PROPERTY ACQUIRED BY GIFT

In the case of property acquired by gift, the basis in the hands of the donee is the same as it was in the hands of the donor (adjusted in certain cases for gift tax paid), unless the donee is claiming a loss and the value at the date of the gift was less than the donor's basis. For purposes of determining loss, the donee's basis is limited to the donor's basis or the fair market value on the date of the gift, whichever is lower.<sup>3</sup> The moral from this rule is that it will generally be inadvisable to make a gift of property the value of which is less than the donor's basis. If a gift is made of such property and if the donee then sells it for less than the donor's basis, no one will be allowed a loss deduction for the depreciation in value suffered while the property was in the hands of the donor.

#### CORPORATE DISTRIBUTIONS

Where a corporation distributes property to its shareholders other than in a liquidation, a noncorporate shareholder's basis for the property

1. INT. REV. CODE OF 1954, § 1012 [hereinafter cited as CODE §].

2. CODE § 1053.

3. CODE § 1015(a), (d).

will be the fair market value of the property at the time of distribution.<sup>4</sup> However, if the shareholder is another corporation, the basis of the property in its hands will be either the fair market value at the date of the distribution or the distributing corporation's basis as adjusted, whichever is lower.<sup>5</sup> If the corporate distribution was in partial or complete liquidation and if gain or loss was recognized on the liquidation, the general rule is that the basis of property received in the liquidation is its fair market value at the date of distribution.<sup>6</sup>

#### PROPERTY ACQUIRED BY EXCHANGE

If property is acquired, not by purchase for money, but in exchange for other property, and if the exchange is not one of the tax-free variety, then the rule that the basis is cost applies. However, in such a situation there may be some difficulty in determining the cost of the property acquired in the exchange. In *Philadelphia Park Amusement Co. v. United States*<sup>7</sup> the court discussed this problem, pointing out one line of authority which holds that cost in this situation is the fair market value of the property given up in the exchange, and another line of authority (which the Court of Claims in this case followed) holding that cost is the fair market value of the property received in the exchange. The theory of the latter rule is that in the taxable exchange the recipient computes a gain or loss measured by the value of the property received in the exchange, and that value should therefore become the basis of the property in the recipient's hands.

#### PROPERTY INCIDENT TO A DEBT

Similarly, if property is received in satisfaction of a debt,<sup>8</sup> or is bid in by the creditor at a foreclosure sale,<sup>9</sup> the basis of the property will be its fair market value at the time of acquisition.

If a group of assets is acquired for a lump sum, the cost must be allocated among them on an equitable basis, which generally will be in proportion to the fair market value of each.<sup>10</sup>

#### PROPERTY ACQUIRED FROM A DECEDENT

Probably the most important area in which cost basis is determined with reference to fair market value relates to property acquired from a decedent. The basis of such property is the fair market value of the

4. CODE § 301(d) (1).

5. CODE § 301(d) (2).

6. CODE § 334(a).

7. 130 Ct. Cl. 166, 126 F. Supp. 184 (1954).

8. I.T. 3548, 1942-1 CUM. BULL. 74.

9. Treas. Reg. § 1.166-6 (1959) [hereinafter cited as Reg. §].

10. See Reg. § 1.61-6 (1957).

property at the date of the decedent's death,<sup>11</sup> or, if the alternate valuation date is elected, the fair market value at the applicable valuation date.<sup>12</sup>

One of the first questions to be resolved is: When is "property" deemed to have been "acquired" from a decedent? Since the enactment of the 1954 Code, the statute has included as property acquired from a decedent virtually all property which was includible in the decedent's gross estate for federal estate tax purposes.<sup>13</sup>

Suppose, however, that the decedent by his will gives someone an option to purchase an asset from his estate at a bargain price. If the optionee exercises the option, then he has acquired the property by purchase, not by inheritance from the decedent, and the basis of the property in his hands will be his cost.<sup>14</sup> In determining his cost, may consideration be given only to the option price, or may the purchaser's cost include the value of the option? It would appear that an option to purchase at a bargain price is in itself property which has value, and that the basis of the property purchased through exercise of the option should include both the value of the option and the amount paid as the option price.<sup>15</sup> The law in this area is unclear; but there is an indication in the *Kalbac*<sup>16</sup> decision (remanding the case on this issue) that this may be held to be the rule.

Another situation where a problem arises in determining what property was acquired from a decedent is where the decedent-lessor owned land, and the lessee has erected a building or other leasehold improvement on the property. For estate tax purposes the decedent's land will be valued as of the appropriate valuation date, and the valuation will be affected by the lease, and perhaps by the existence of the leasehold im-

11. Reg. § 1.1014-3 (1957) states that the value of property as determined for federal estate tax purposes shall be deemed to be its fair market value for purposes of determining basis; and if no federal estate tax return is required to be filed, then the value as determined for state inheritance tax purposes shall be used. It is well settled, however, that such a determination is not conclusive, but is merely a presumptive value which may be rebutted by clear and convincing evidence. Rev. Rul. 54-97, 1954-1 CUM. BULL. 113. See also Elizabeth G. Augustus, 40 B.T.A. 1201 (1939), *aff'd*, 118 F.2d 38 (6th Cir.), *cert. denied*, 313 U.S. 585 (1941).

12. CODE § 1014(a). Section 1014(a) makes clear, however, that this rule does not apply to property acquired from the decedent during his lifetime (for example, by a gift in contemplation of death) if the person who acquired the property by transfer from the decedent has sold, exchanged, or otherwise disposed of the property during the decedent's lifetime. If, however, such a person has purchased new property which is deemed property "acquired from a decedent" (by reason of its being includible in the decedent's gross estate for estate tax purposes or for any other reason), then such new property will, of course, take a basis equal to its value at the date of the decedent's death under the general rule of CODE § 1014(a).

13. CODE § 1014(b)(9). The statute, however, expressly excludes annuities described in § 72 [CODE § 1014(b)(9)], and property which constitutes an item of income in respect of a decedent under § 691 [CODE § 1014(c)].

14. *Kalbac v. Commissioner*, 298 F.2d 251 (8th Cir. 1962).

15. *Cf. Stires Corp.*, 28 B.T.A. 1 (1933).

16. *Kalbac v. Commissioner*, 298 F.2d 251 (8th Cir. 1962).