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Basis Shifting - A Radical Approach to an Intractable Problem

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BASIS SHIFTING — A RADICAL APPROACH TO AN INTRACTABLE PROBLEM

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Coven asserts that one of the lingering ambiguities in subchapter C is how an appropriate tax benefit can be obtained from the tax basis that “disappears” when a shareholder’s interest is completely redeemed but the transaction is treated as a dividend because stock held by others is attributed to the former shareholder. He believes that Treasury was content to rely on manifestly inadequate regulations to resolve that issue until taxpayers discovered how to convert those regulations into a potent tax shelter. The amendment to the regulations, proposed in 2002, however, was fatally flawed, according to Coven.

In this article, Coven proposes a novel solution to the disappearing basis problem that would preserve existing law for most individual taxpayers while preventing the trafficking in basis used in tax sheltering. Because the proposal relies on fundamental tax rules for its result, it renders the amendment of the regulations unnecessary.

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Under the codification of the step transaction/substance-over-form doctrine contained in section 302, if a shareholder purports to sell stock back to the issuing corporation but the transaction does not result in a sufficient proportionate reduction in the shareholder’s continuing interest in the corporation, the sale will be recast as a dividend. In that event, assuming adequate earnings and profits, the entire amount of the proceeds of the sale become subject to tax and the shareholder will obtain no benefit from his basis in the retired stock. That raises the important question of just what does happen to the unused basis.

In common with other applications of these reconstructive doctrines, whether judicial or congressional, section 302 does not say: The matter is left to be resolved by regulations. Unfortunately, the regulations have failed to do that for nearly 50 years. That notorious omission, once merely annoying, has blossomed into an embarrassing tax shelter.\(^1\) That development forced Treasury to act and in 2002 a regulatory solution was somewhat belatedly proposed.\(^2\) Unfortunately, the proposal was (I hope) a failure. The proposal reached results that were inappropriate in a wide range of cases and would have been extremely difficult for both taxpayers and the IRS to apply. It was strongly criticized by both practitioners\(^3\) and academics\(^4\) and apparently will be allowed to drift into oblivion. Nevertheless, the problem it addressed remains.\(^5\) Fortunately, there is a better way and it may not require revising the existing regulations at all.

I. The Problem

To understand how the problem of basis shifting occurs and how it should be resolved, it will be useful initially to focus on two specific illustrations.

Example 1. In 2000 Husband purchased all of the stock of X Corp. for $100,000. In 2001 he gave...
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one-half of the stock, valued at $60,000, to Wife. In 2004 all of the stock retained by Husband is re­deemed by X Corp. for $150,000. At the end of that year X Corp. had earnings and profits of over $150,000.

Under section 302, this redemption would be treated not as a sale but as a dividend to Husband taxable under section 301. The reason for that result lies in the stock attribution rules of section 318. The transaction would constitute a complete termination of interest and thus would be entitled to sales treatment under section 302(b)(3) except for the fact that the stock held by Wife will be attributed to Husband. Because of that attribution, Husband's continuing proportionate interest in X Corporation has not declined. Rather, he is treated as owning 100 percent of the corporation both before and after the redemption. While attribution from family members can often be waived on facts similar to this,9 because Husband gave stock to Wife within 10 years of the redemption, attribution cannot be waived absent a showing that the gift to Wife was not for tax avoidance purposes.7 Accordingly, the entire $150,000 amount would be taxable as a dividend.

Example 2. Domestic Individual and Foreign Partner, a Dutch individual, each own 50 percent of the stock in Foreign Corp., a French corporation. Foreign Partner wishes to dispose of all of its interest in Foreign Corp. To that end, Foreign Partner acquires from Domestic for a small investment a nontransferable option to purchase all of Domestic's stock in Foreign at a price that is 150 percent of its current value and exercisable during a 30 day period 10 years in the future. Foreign Partner then causes all of its stock in Foreign Corporation to be redeemed. Under section 302, this redemption would also be treated as a dividend although, because the dividend is not U.S.-source income, it would not be subject to tax by the United States. Again, the explanation lies in the stock attribution rules. Because Treasury has never developed economically rational limitations on the option attribution rule,8 all of the stock subject to the option will be attributed to the holder of the option, Foreign Partner. Thus, Foreign Partner would be treated as owning 100 percent of Foreign Corporation both before and after the redemption. Accordingly, the entire distribution, equal to 50 percent of the net worth of Foreign Corporation, would be treated as a dividend.

In both examples, the retiring shareholder had a substantial tax basis in the stock that was redeemed. And, in both examples, the shareholder did not obtain any tax benefit from that basis in the redemption because under sections 301 and 302, the entire proceeds of the redemption were subject to tax. Accordingly, the question arises of how a tax benefit is to be obtained from this basis that seemingly “disappeared” in the redemption. If that benefit is to be obtained, it must be obtained from rules or concepts that exist outside of section 302.

One possible solution to that disappearance would be that no tax benefit could be obtained from the stock basis. That, however, is simply not an acceptable answer (despite what the IRS once so asserted).9 Our fundamental notion of income requires an accretion to wealth — gain, that is. If a taxpayer is denied a tax-free recovery of an amount equal to the after-tax funds invested in the venture, a tax will be imposed on more than income. Whether or not that denial would be constitutional,10 a full basis recovery, or a compensating loss, is integral to our very concept of income. Accordingly, the question requires an answer.

To the extent that there is an answer to that question, it is found in regulations under section 302 that, until recently, have remained unchanged since 1955. In text, those regulations provide that “a proper adjustment of the basis of the remaining stock will be made.”11 When the redeemed shareholder continues to hold other stock in the corporation, a fair construction of that brief instruction would require adding the basis of the redeemed stock to the basis of the remaining holdings although, if the stock retained were of different classes, questions would arise concerning the proper allocation. However, when the redeemed shareholder is left holding no stock of the corporation at all, that statement is of no help. Even aside from the vagueness of the “proper adjustment” injunction, there is no indication of what stock is to be treated as “remaining.”

Fortunately, the regulations contain examples that elaborate on the text of the regulation and one such example12 is identical to example 1. The regulatory example concludes that “W holds the remaining stock...with a basis of $100,000” [emphasis added]. Because in this example there is no other stock outstanding, the statement that W holds the remaining stock is an undeniably true statement of fact. However, the example contains no guidance regarding the principle that might be applied to determine the identity of the remaining stock in a more complex case. The reader is left to speculate on the importance of the family relationship, the transfer of the stock from Husband to Wife, the recency of that transfer, or the fact that after the shifting of basis Wife still had a gain in her stock! Nevertheless, the example does make clear that under some circumstances, when all of the stock of a shareholder is redeemed, the basis of that stock will shift to another taxpayer.

In the normal course of events, tax basis attaches to a specific property and either is automatically exercised when that property is transferred in a taxable transaction, is preserved for future exercise in replacement property,
or follows the property into the hands of a transferee. In general this right — basis, that is — is not detached from the underlying property; it is more an aspect of the property than a separate, or separable, right. Indeed, this author is not aware of any other place under the income tax laws when basis is separated from the underlying property. The rarity with which that detachment occurs may suggest that detachment is not the appropriate solution to the disappearing basis under section 302. Nevertheless, detachment has been required by the regulations for almost 50 years. While the results obtained under the regulations have not always been ideal, it cannot be doubted but that its solution have become a part of the fabric of the tax law — at least for redemptions treated as dividends because of family attribution.

In fact, the result reached in the regulatory example seems correct. In example 1, it makes perfectly good sense to shift Husband's tax basis for his stock to Wife. As a result of the combination of Husband's gift of stock to Wife and the subsequent redemption, Husband has transferred his entire interest in the corporation to Wife. Accordingly, it seems logical and appropriate for any remaining attributes of that stock, including Husband's unused basis, to similarly flow from Husband to Wife. Indeed, because the stock now held by Wife was previously owned by Husband, the basis is merely being reattached to the stock of which it originally was a part.

While the regulatory example presents what may be the strongest case for the result it reaches, most observers would likely regard the result as equally appropriate on much less extreme facts. Any complete redemption of the actual stockholdings of an individual results in a shift of the ownership of the corporation from the redeemed shareholder to others. If dividend equivalency has been found because of attribution from individuals, remaining shareholders must largely be members of the redeemed shareholder's family. Thus, even if stock has not recently been transferred expressly from the redeemed shareholder to those family members, the result of the transaction nonetheless involves a shift of ownership among the family members not unlike the transaction in the regulatory example. In that case it is entirely appropriate for the remaining incidents of stock ownership, the unused basis, to be shifted to those same family members.

A complete redemption may also be treated as a dividend if stock is attributed to the retiring shareholder from an entity in which the shareholder retains an interest. Said differently, stock indirectly owned by the retiring shareholder through entities, including family-controlled corporations, family trusts, and partnerships, is attributed to the retiring shareholder and must be taken into account when testing whether the redemption should be treated as a dividend. In those cases of indirect ownership it is all the more appropriate for the basis in the stock that has been actually owned by the shareholder to be shifted to the stock that is indirectly owned by that shareholder.

The conclusion that a shift of basis is an appropriate resolution of the disappearing basis problem is reinforced by a comparison of the alternatives. If the basis is not shifted to a family member, it must be retained by, and generate a tax benefit to, the retiring shareholder. That tax benefit can only be a capital loss, available either at the time the stock is redeemed or at some future date. However, capital losses produce a tax benefit to individuals only to the extent of $3,000 per year unless the taxpayer derives capital gains to offset. Accordingly, to an individual who has a modest or conservatively invested portfolio, a large capital loss incurred late in life will too often be essentially worthless. Shifting the basis to the family members to whom ownership in the corporation has been shifted avoids that harsh and unfair result.

However, in some circumstances the grant of a capital loss would be too favorable. After all, redemptions are treated as dividends because they are the financial equivalent of dividends and therefore ought to be taxed in the same manner. If a capital loss were available on a dividend-equivalent redemption but not on a regular dividend, redemptions would be treated more favorably than dividends, which could lead to arguably inappropriate tax planning. The IRS, at least, harbors this objection.

In summary, a strong case exists for applying the basis shifting approved by the existing regulation to a broad category of redemptions of individual shareholders from family-owned businesses. A different question, however, is presented by the redemption in example 2.

Example 2 also involves the complete redemption of all of the stock actually owned by the shareholder that is treated as a dividend because the stock is attributed to the shareholder from others. Unlike example 1, however, the shareholders in example 2 are economic strangers. Stock is attributed among them, not because they are a part of the same family or economic grouping but because of the existence of a commercial arrangement between them, one presumably negotiated at arm's length. Unlike the specific facts of the regulatory example, stock has not been transferred among those shareholders either directly or indirectly — nor is their relationship such that stock normally would be transferred among them. On those facts, shifting the basis of the stock owned by Foreign Partner to Domestic Individual would be a surprise, a result that does not seem warranted by their relationship.

It is not clear that it is reasonable to conclude that the shift of basis specified by the regulatory example would also apply to a redemption treated as a dividend because of other forms of attribution — such as the option attribution contained in example 2. The factual conditions that support a basis shift in example 1 are wholly lacking in example 2, and, accordingly, shifting basis lacks the appearance of a reasonable and logical solution. Nevertheless, during a half century of silence from the IRS, taxpayers have been required to provide their own solutions to the disappearing basis problem. Because the only guidance available indicated that basis should be

\[\text{Section 318(a)(2).}\]

\[\text{Preamble to Prop. reg. section 1.302-5, 67 Fed. Reg. 64334.}\]
shifted to the stock that was attributed and thus caused the redemption to be treated as a dividend, it was not unreasonable for taxpayers to conclude that the regulatory example could be applied to any manner of redemption. Taxpayers have indeed made that assumption for decades.\(^1\) Accordingly, under current law in example 2 basis would shift from Foreign Partner to Domestic Individual even though, as a matter of sound income tax policy, that result is problematic.

II. The Solution

While basis may shift to other shareholders following a complete redemption, including wholly unrelated shareholders, the answer to the problem of the disappearing basis provided by the regulations is not complete. The existing regulations, while mandating a shift of basis, do not address the collateral income tax consequences of that shift. Tax basis, stripped to its essence, is a right contained in the income tax laws that entitles a taxpayer to receive an amount that otherwise would be subject to tax on receipt, free from that tax. That right is undeniably valuable and enhances the net worth of its holder. The regulations, in requiring that transfer of tax basis from one taxpayer to another, accomplish the transfer of a valuable property right. As would occur in connection with the transfer of any other property right, under the tax laws, that transfer has income tax consequences. In particular, the mandated transfer results in an economic loss to the transferor and an economic gain to the transferee. Those economic losses and gains should be given the same income tax consequences as those for any other property transfer.

As described below, in the interspousal example given in the regulations, the tax consequences proposed here would not have altered the result reached under the example. Accordingly, the failure of the regulations to specifically address the collateral tax consequences of the transfer of basis was insignificant. However, in other cases, particularly cases involving deliberate tax shelters, those collateral consequences would be very significant.

There are no obvious precedents for treating transfers of basis as creating taxable income and loss because, aside from the transaction in question, basis is not separately transferable. Nevertheless, treating the receipt of basis as income follows quite automatically from the broad notion of income embodied in section 61 and from the equally broad definition of income under the tax laws endorsed by the Supreme Court in such cases as Glenshaw Glass.\(^2\) As the Court said in that opinion, "Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." The Court could have been talking about the receipt of basis. Because the economic benefit from the receipt of basis is evident and, as the Court further observed, "Congress [intended] to exert in this field 'the full measure of its taxing power,'" it must be presumed that a shift of basis will result in income absent a clear reason for excluding the receipt from income. No such reason appears. The fact that the IRS has failed to recognize and to tax that element of income in the past cannot forestall the government from taxing this income in the future.

That taxing the receipt of basis flows from section 61 rather than the regulations under section 302 is important to the implementation of this concept. No amendment to the regulations is required to impose this tax or to allow the corresponding loss. Indeed, the consequences of the shift of basis pointed out here has always been a part of the law; the IRS has simply overlooked the matter.

The amount that must be subject to tax following a taxable shift of basis follows from the effect on the transferee of the receipt of basis. It is axiomatic under our taxing system that when an amount has been subject to tax, the taxpayer is entitled to a basis increase equal to the amount that was subject to tax. It follows that in our context, to be entitled to a basis increase in a given amount, that amount must be subject to tax. Thus, it is the full amount of the basis shifted to a transferee that must be subject to tax. For example, on the receipt of basis in the amount of $10,000, a taxpayer in the 30 percent bracket would pay a tax of $3,000 and thereby become entitled to a basis increase of $10,000. That is the correct result under our tax system.

III. Applying the Solution

A. In General

When, as in the regulatory example, the transferee is the taxpayer's spouse, the transfer should be treated as are other interspousal transfers — either as gifts or as quasi-gifts under section 1041 — to both parties. Applying that rule to example 1, the transfer of basis would have no income tax consequences to Husband. A donor of property incurs neither income nor loss. Similarly, the receipt of the gift of basis by Wife would not be taxable to her. Gifts are not subject to income taxation.\(^1\) While it is uncomfortable to speak of the basis in basis carrying over from Husband to Wife, through the receipt of a gift of basis, Wife will increase the basis of her stock in the corporation by the amount of the basis of the stock previously held by Husband.

A similar result should be reached in any case in which transfers of property would be treated as a gift. Thus, all intrafamily shifts of basis, not clearly occurring in a commercial context, should continue to be accorded the income tax consequences specified in example 1.\(^1\) As argued above, that construction of the basis shifting

\(^1\)See, e.g., ABA Section of Taxation Comments. In these comments to Treasury, the Section states that the regulatory example discussed in the text "provides" that following a redemption of all shares actually owned, unused basis shifts to stock attributed to the redeemed taxpayers. That unqualified statement constitutes the broadest possible interpretation of the example and reflects the view long held by practitioners.

regulations produces a result that appears reasonably consistent with the facts that normally surround such a redemption.

However, a transfer of property between persons or entities standing in a commercial, rather than personal, relationship, does not constitute a gift absent clear evidence to the contrary.19 In the absence of that exception to the scope of section 61, the transfer of basis would have significant income tax consequences — just as would the transfer of any other property between the parties. For the transferor, the compulsory transfer of the right that constitutes basis produces a loss in an amount equal to the amount of basis so transferred. There is no reason that loss should not be recognized for income tax purposes in the same manner as any other investment loss. To illustrate, assume, for example, that stock having a tax basis of $50,000 is redeemed for $75,000 but the transaction is treated under section 302 as a dividend. In that event, while the taxpayer is not entitled to a loss on the redemption of the stock, the taxpayer is entitled to a loss attributable to the loss of that basis in the amount of $50,000. Assuming that the stock was a capital asset in the hands of the taxpayer, the loss would be a capital loss.20

More importantly, for the transferee the receipt of a right to convert taxable income into tax-exempt income in the form of a transfer of basis is the receipt of a valuable property right and that constitutes income. Income to the transferee is the inescapable reverse of the loss to the transferor. And, of course, the amount of income to the transferee is the same as the amount of the loss to the transferor: the amount of basis so acquired. Thus, continuing the above illustration, the transferee would receive an upward basis adjustment of $50,000 in the stock of the corporation but would also be in receipt of immediately taxable income in the amount of $50,000. Because that income is not attributable to the sale or exchange of a capital asset, it presumably constitutes ordinary income.

This analysis thus provides the answer to example 2. As required by the existing regulations, Foreign Partner’s basis for its stock in Foreign Corporation shifts to Domestic Individual because the stock held by the individual was attributed to Foreign Partner. However, that loss of basis results in a capital loss to Foreign Partner. Moreover, the receipt of basis correspondingly results in ordinary taxable income to Domestic Individual. Those results are not only technically correct but they also are consistent with sound income tax policy. As a result of the imposition of this tax, taxpayers will be unable to benefit from the shifting of basis in commercial arrangements.

B. Entity Attribution

Because the solution to the disappearing basis problem suggested here is based on fundamental income tax principles, in some situations it produces a result that is superior to current law. As applied to corporations as a result of entity attribution, however, the result, while technically correct, may require further refinement.

Example 3. Individual A invests $10,000 in X Corp. and $7,000 in Partnership. Individual B invests $3,000 in Partnership, and the Partnership then invests the $10,000 in X Corp. When the value of X Corp. has doubled, all of the stock of Individual A is redeemed. If all the appreciation from these investments were realized, A would have a gain of $17,000 and B would have a gain of $3,000.

A’s redemption would be treated as a dividend because 70 percent of the stock in X Corporation held by the partnership would be attributed to A.21 As a result, assuming sufficient earnings and profits, A would be taxed on income of $20,000. Under the current basis-shifting regulations, A’s unused basis of $10,000 would shift to the partnership. Accordingly, the partnership would have a basis of $20,000 for its stock in X Corporation which was also worth $20,000. If that stock were redeemed and the proceeds distributed to the partners in liquidation of the partnership, A would have an amount realized of $14,000, a basis for the partnership interest of $7,000, and a resulting gain of $7,000.22 Thus, A would be taxed on a total gain of $27,000. B would be taxed on a gain of $3,000. A clearly has been overtaxed.

If the shift of basis were given its ordinary income tax consequences, as suggested here, the shift in basis would be treated as a contribution to the partnership by A. As a result, A’s basis in his partnership interest would be increased by $10,00023 to $17,000. Accordingly, on the immediate liquidation of the partnership and the distribution of $14,000 to him, A would incur a loss of $3,000. His net total gain would thus be $17,000, the correct result.

If the partnership rather than Individual A were redeemed under current law, A would be undertaxed. The redemption would be taxed as a dividend because all of the X Corporation stock owned by A would be attributed to the partnership. A’s share of partnership income would be $14,000, but that income would increase his basis for the partnership interest to $21,000.24 On the liquidation of the partnership, he would incur a loss of $7,000. Because A would have no income from his direct investment in X Corporation as a result of the shift of basis to him, his net total taxable gain would equal only $7,000. Under the proposal here, the shift of basis from the partnership to A would be treated as a distribution that would reduce A’s basis by $10,000, from $21,000 to $11,000.25 Thus, on the partnership liquidation

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20The character of the basis would be derived from the character of the property of which it had been a part.

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21Before the redemption, A owned 50 percent of the X Corporation stock directly and 35 percent constructively through attribution from the partnership. After the redemption, A constructively owned 70 percent of the remaining outstanding stock, or 82 percent of his prior holdings. The redemption would thus fail all of the tests of section 302(b).
22Section 731(a).
23Section 722.
24Section 705(a)(1).
25Section 733.
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he would have a gain of $3,000, which, when added to his income of $14,000, produces the correct result.

The application of income tax principles to shareholder-corporation transactions is similar. However, because of the manner in which this approach would interact with the double taxation of corporations, the results are surprising. For this example, it is assumed that those corporations are not subject to section 1059, the effect of which is discussed below.

Example 4. Individual A invests $10,000 in each of X Corp. and PHC Corp. PHC Corp. in turn invests the $10,000 in X Corp. When the value of X Corp. doubled, the corporation redeemed all of its stock held by PHC Corp. for $20,000. A has a gain of $10,000 on each of her investments; PHC also has a gain of $10,000 on its investment in X Corp.

The redemption would be treated as a dividend to PHC Corp. in the amount of $20,000 under section 302 because all of the stock in X Corporation held by A would be attributed to it. The unused basis in its X Corporation stock would shift to A. If that shift were given its normal income tax consequences as suggested here, that transfer from corporation to shareholder would be treated as a dividend of $10,000, fully taxable to A and not deductible by PHC Corp. As a result of the receipt of basis, A would own stock in X Corporation having a value of $20,000 and a basis of the same amount and would avoid all taxes on that investment. On the liquidation of PHC Corp., A would have a gain of $10,000.26 The net result of the investment would be income of $20,000 to A and income of $20,000 to PHC Corp.

The reason that the total gain on A's investments is $40,000 rather than $30,000 lies in the double taxation of corporations. The somewhat artificially inflated income attributed to the corporation was duplicated in the amount subject to tax would be achieved because the shift of basis has income tax consequences and should be accorded income tax consequences. Thus, when basis is shifted from a corporate corporation. The identity of the shareholder does not inevitably be treated as an extraordinary dividend under section 1015, bars the shifting of loss among family members in connection with the making of gifts. Thus, on the gift of property containing a built-in loss, the basis of the property in the hands of the donee for the purpose of computing loss is limited to the fair market value of the property on the date of the gift.

Consistent with the rule of section 1015, it would not be appropriate to allow Child to claim a loss attributable to basis acquired by gift. Accordingly, her basis in her stock for the purpose of claiming a loss must be limited to $75,000. Consistent with the regulations to section 1015, however, Child's basis in the stock for the purposes of computing gain would be $100,000.

B. Corporate Shareholders

The foregoing analysis should not change, because the shareholder from which or to which basis is shifted is a corporation. The identity of the shareholder does not alter the fact that the loss or receipt of basis has economic consequences and should be accorded income tax consequences. Thus, when basis is shifted from a corporate shareholder, the recipient shareholder should be subject to tax. However, there may be a question as to just when basis is shifted from a corporate shareholder following a redemption.

A redemption by a domestic corporate shareholder that is treated as a dividend under section 302 will almost inevitably be treated as an extraordinary dividend under whether the shareholder or the investment corporation executes the redemption is a doubtful result — although it is not different from the current law treatment of redemptions by partners and partnerships noted above. While there does not appear to be a principled approach that would produce the same tax burden regardless of the identity of the redeeming shareholder, the same results in example 2 can be achieved by matching the income from the dividend with a loss to the paying corporation and matching the basis increase from the capital contribution with income to the shareholder.

IV. Refinements

A. Creating Losses

Example 5. As in example 1, Husband makes a gift of one-half of his stock, with a basis of $50,000, to a family member. This time, however, the gift is to Child and the appreciation in the stock was more modest. Husband's stock was redeemed for only $75,000.

If Husband's basis in the redeemed stock is shifted to Child as in example 1, Child will have a basis of $100,000 in stock that has a value of $75,000. Husband, that is, will have incurred a gain but shifted a loss to Child. That result seems incorrect. Long and firmly established tax policy, embodied in section 1015, bars the shifting of loss among family members in connection with the making of gifts. Thus, on the gift of property containing a built-in loss, the basis of the property in the hands of the donee for the purpose of computing loss is limited to the fair market value of the property on the date of the gift.

Consistent with the rule of section 1015, it would not be appropriate to allow Child to claim a loss attributable to basis acquired by gift. Accordingly, her basis in her stock for the purpose of claiming a loss must be limited to $75,000. Consistent with the regulations to section 1015, however, Child's basis in the stock for the purposes of computing gain would be $100,000.

20Reg. section 1.1015-1(a)(2). It does not appear, however, that this limitation on basis would apply to basis shifts among spouses. Under section 1041, which apparently overrides section 1015 (reg. section 1.1041-1T(Q&A-2)), the basis of property containing a built-in loss is not limited to the value of the property. Thus, between spouses, losses may be transferred.

section 1059. That section imposes its own tax consequences on the redeemed shareholder and those consequences include extending to the redeemed shareholder a tax-free recovery to the extent of the basis of the stock in the redeeming corporation held by the redeemed shareholder. The question is whether that basis is determined before or after the application of the basis rules under section 302. Regrettably, there is no express coordination of section 1059 with the basis rules of section 302.

Section 1059 comes into play only after section 302 has been applied to the transaction to determine that the redemption is equivalent to a dividend. The basis shifting rule, of course, is a part of section 302. Accordingly, it might well be argued that, following the complete redemption of the shareholder’s actual holdings, the basis of the redeemed stock has shifted to another before section 1059 is applied. On the other hand, section 1059 does appear to assume that the shareholder subject to its provisions has a basis in the stock that was redeemed. If the shareholder had lost the benefit of that basis, it would be taxed at capital gains rates on the entire proceeds of the redemption, a harsh result that would go beyond imposing the same tax as if the stock were sold. While the text of the code is ambiguous, the IRS is apparently of the view that basis is not shifted from stock the redemption of which constitutes an extraordinary dividend under section 1059. Accordingly, it appears that, following a redemption from a domestic corporate shareholder that is treated as an extraordinary dividend under section 1059, basis does not shift to other shareholders.

Whether section 1059 applies to a foreign corporation, however, is a more difficult question. It has been generally assumed that it does not. It is true that section 1059 was enacted to prevent corporate shareholders from misusing the dividends received deduction provided principally by section 243 and that foreign corporations do not receive the benefit of that deduction. Moreover, it might be true that, because the foreign corporation did not receive the benefit of section 243, applying section 1059 to the corporation would produce a result that is either meaningless or senseless. However, it is also true that there is nothing on the face of section 1059 that limits its application to domestic corporations. The possibility exists, therefore, that the IRS might argue that section 1059 does “apply” to foreign corporations — although how it applies may be unclear. In that event, it would seem that, as with the treatment of domestic corporations, basis could not be shifted from a foreign corporation following a dividend-equivalent redemption.

Those ambiguities do not have to be resolved here. To the extent that basis continues to shift from a corporate shareholder following a complete redemption of the shareholder’s actual holdings, that shift ought to be subject to the income tax treatment suggested here. Thus, if, in our example 2, the Foreign Partner was a Dutch corporation rather than a Dutch individual, the domestic shareholder, whether individual or corporate, would receive the basis adjustment that is assumed to flow from the existing regulations but would also be subject to income taxation on the amount of that adjustment.

C. Mitigating Circumstances

While in a case such as illustrated by example 2 taxing the transferee on the receipt of this basis while giving a capital loss to the transferor is clearly the correct technical answer, it is also a harsh result. Extracting an immediate tax, compensated only by a future reduction of gain through a basis increase, is an appropriate response to a taxpayer who devised a transaction lacking in business purpose only to avoid an income tax liability. However, it is a heavy price to impose on a taxpayer whose only sin was to have stock held by it attributed to another under section 318. In less abusive cases, a less burdensome rule might be in order.

An alternative to the immediate recognition of income to the transferee followed by a basis increase would be to eliminate the basis increase and accordingly eliminate the taxation of the receipt. That netting of the benefit and the burden of the basis shift would be more favorable to taxpayers than the more rigorous approach suggested here because it would defer the tax otherwise payable on the receipt of basis to the time at which the stock, the basis of which would have been adjusted, is sold. However, this more favorable approach nonetheless eliminates the benefit of the basis shift obtained under current law and thus would prevent the creation of a basis-shifting tax shelter. Consideration should be given to allowing that netting approach, either on an automatic or discretionary basis, to taxpayers not engaged in deliberate tax sheltering.

Of course, that netting of the consequences to the transferee shareholder should not have any effect on the redeemed shareholder. That shareholder would remain entitled to claim a loss for the otherwise unused basis. As a result, the overall effect of allowing a netting approach to the transferee would be the same as eliminating the shift in basis required under the existing regulations and allowing the redeemed shareholder to claim a capital loss at the time of the redemption.

V. Conclusion

The shifting of basis mandated by the existing regulations works better than any alternative for the average taxpayer who is not engaged in tax manipulative behavior. However, basis shifting can be abused and cannot be available to all taxpayers. The suggestion here is an approach that appears to preserve basis shifting when appropriate but to bar it in tax sheltering activities. As an important side benefit, treating the basis shift as having income tax consequences, including creating taxable income, produces results that are superior to both the existing and the proposed regulations. Indeed, the proposal would improve the internal integrity of the taxing system.

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29Section 1059(a)(1).
30The regulations that have been proposed under section 302 somewhat vaguely provide that they apply only “after adjusting such basis to reflect the application of section . . . 1059.” Prop. reg. section 1.1302-5(a).
COMMENTARY / SPECIAL REPORT

In some areas of the code, such as in the taxation of partnerships, aggressive tax planning by sophisticated taxpayers has precipitated legislative responses that have ruined the utility of those rules for the average taxpayer for whom prior law worked perfectly. That same phenomenon threatens the basis rules under section 302. This article has suggested the "radical" approach of applying fundamental income tax principles to the abuses rather than creating complex, idiosyncratic rules.

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