ValpoScholar Valparaiso University Law Review

Volume 22
Number 2 *Winter 1988*

*pp.*233-274

Winter 1988

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Valparaiso University Law Review

Volume 22 Winter 1988 Number 2

ARTICLES

DID YOUR LAW PROFESSOR TELL YOU BASIS MEANS COST? THE RECOGNITION THEORY OF BASIS

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I. INTRODUCTION

This article advances a new theory of basis in United States federal income taxation law in the context of a primer on basis as a system. This theory will more readily be grasped by viewing basis in its natural environment — a dynamic conceptual system possessed at its ultimate core of a unifying coherency. Examples chosen will be simple, but will build, for pur-

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poses which transcend particulars.

This new recognition theory addresses the theoretical underpinning of basis in situations where measuring income and taxing it are goals. The theory accommodates all income situations, whether recognition is current or deferred. It is not addressed to those features of the tax expenditure system,[1] a vast spending rather than taxing apparatus, whose purpose is to prevent certain income from ever being recognized. When provisions are directed toward preventing income taxation, one would not expect events to fit a coherent theory of income taxation.

Initially, the general statutory framework provided by the Internal Revenue Code for measurement of income from particular transactions will be presented, for this is the basic structure of which the mechanism of basis is an integral part. Then, the historical background of the entrance of the terms "basis" and "cost" into the statutory scheme in the years following passage of the sixteenth amendment will be examined. This examination will show that the word "basis" was originally intended to be used in its ordinary sense and that its use came about by accident, with no intention that the word become a special tax term of art. The historical analysis of the words "basis" and "cost" will further show that interpreting "basis" in light of its plain meaning is an insightful way of viewing the term when used today. Thereafter, recognition alone will be shown to be the only rule of basis that explains why the basis amount should be subtracted in all situations in which income measurement and taxation are intended.

In the course of this analysis, the rule that basis means cost, even sometimes, will be shown to be a myth. Viewing basis as cost will be shown to represent a fundamental misunderstanding of this foundational building block of income taxation. Cost and its various exceptions will be shown to be a maze of rules that vary from situation to situation and therefore lack conceptual integrity. This lack of coherency will be illustrated by a series of six examples: 1) a purchase; 2) a taxable property exchange; 3) a taxable property exchange in which the properties are not equal in value; 4) a like-kind exchange, which is called non-taxable but is really tax-deferred; 5) a mixed like-kind exchange; and 6) a sale. The manner in which realized gain is calculated in each of these situations will be explained. The exact operation of basis in each instance will be explored as well. The applicable rules will be given for each situation and will be tested for system-wide applicability in other situations.

The purpose of this entire analysis is to find a unifying theme which

1. *See generally* EXECUTIVE OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSIS G, BUDGET OF THE UNITED STATES GOVERNMENT (FY 1986) [hereinafter SPECIAL ANALYSIS G]. The tax expenditure system is a spending system, not a taxing system, notwithstanding its disharmonious grafting onto the income tax system.

applies across the field of basis, thus representing a coherent theory of the meaning of the term. Recognition is this unifying theme. Ultimately, basis as amount recognized, exclusively, will be discussed in the context of the system as a whole. Finally, the article will include a discussion of the purview of the system of basis.

II. Structural Mechanisms For Gain Measurement

To be true to its name, income taxation law must involve the measurement of income and its taxation, once and only once.[2] Although efforts have been made frequently and successfully to use income tax systems for additional purposes,[3] a system ceases to be an *income tax system* to the extent that public policy objectives are imbedded in the law to prevent achievement of these inherent purposes. When this happens, the system loses its conceptual integrity.

2. United California Bank v. United States, 439 U.S. 180, 194 n.14 (1978).

3. Tax expenditures were expected to total $456,895,000,000 for fiscal year 1986. *See generally* Special Analysis G, *supra* note 1. This sum of indirect spending is well over double the then projected annual deficit for 1986 of $180,000,000,000. Budget Totals By Fund Group, Budget of the United States Government, 6-25 (FY 1986). Objection to the idea of using the taxing power to accomplish social policy objectives is not new:

> The financial history of the United States points with peculiar emphasis to one fact, and that is the danger of employing a power granted for one purpose for a purpose entirely different. In the discussions upon the first revenue law, Mr. Clymer of Pennsylvania, one of the few men who saw the tendency of the language employed, desired a separation of the bill into two parts; one of which should contemplate revenue alone and be shaped entirely by revenue principles. This suggestion was not, however, favorably accepted; and as a consequence, there was included in the first finance bill, in addition to provisions for securing a revenue, part of the country's navigation laws and the major part of its formulated foreign policy. Although, as has been shown, the distinctively protective character of revenue acts does not make its appearance till much later, it yet remains true that a precedent for using revenue machinery in a loose manner was then established, and out of this precedent have grown many of the abuses which subsequent history discloses.
>
> Looked at from this point of view, one may hold the first Congress responsible for the dangers that threatened the country in 1831, for the disasters that followed the distribution scheme of 1836, and for the absurd position in which the people of the United States now find themselves, — with an overflowing treasury and yet unable to shut down the floodgates of revenue. The financial reform which this day requires is more than a modification in tariff-rates; it consists rather in such a revolution of public sentiment that finance laws may be judged on the basis of financial principles, and revenue-machinery be employed primarily, if not solely, for revenue-purposes. If the disturbing element of protection can in this manner be separated from questions of finance, the injustice and expense of paying a subsidy out of public funds for the support of losing industries will clearly manifest itself. Tariff-reform means tariff for revenue only.

Henry C. Adams, Taxation In The United States 1789-1816, at 78-79 (Burt Franklin 1970). "Unyielding resistance should be offered to any endeavor to make the income tax law the means of forcing amelioration of social conditions." Joseph J. Klein, Federal Income Taxation, at xvii (1929).

The verbal formulation that an income tax system measures income and taxes it once seems obvious. However, carrying out these objectives in any pure sense has proved vexing. Aside from policy roadblocks, numerous conceptual and technical problems exist in any comprehensive income tax system.

Identification of *what* is income presents its own challenges. The United States statutory scheme does not define income, but does give guidance. Sections 61, 62, and 63 of the Internal Revenue Code (I.R.C.) define gross income, adjusted gross income, and taxable income, respectively. These legal concepts are all to be distinguished from the concept of income, which is an economic concept. By defining gross income as "all income from whatever source derived,"[4] the statutory scheme presupposes knowledge of the meaning of the word "income."

The Code is more helpful in explaining income derived from particular transactions. When property is sold, for instance, I.R.C. § 61(a)(3) tells us that the "[g]ains derived from dealings in property" are included in gross income.[5] I.R.C. § 1001(a) further helps to interpret the meaning: gain "from the sale or other disposition of property" is the excess of the "amount realized" over the property's "basis," properly adjusted for well-recognized changes in basis. In adding that "the loss shall be the excess of the adjusted basis . . . over the amount realized,"[6] the subsection merely re-orders its first statement with negative signs in front of each component.

True to its general writing style and penchant for certainty of meaning, the Code goes on to define the significant new terms — "amount realized" and "basis." The phrase "amount realized" has the meaning one would expect, but is expressed rather oddly in section 1001(b) as "the sum of any money received plus the fair market value of the property (other than money) received."[7] The final element in the definition of "gain" is the concept of "basis." Aside from adjustments to basis, the statement that basis means cost is commonplace.[8] This reflects the statutory language in I.R.C. § 1012 which states that the "basis of property shall be the cost of such property."[9] An analysis of the historical development of this terminology will shed light on the usefulness of this legal maxim.

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4. I.R.C. § 61(a) (Supp. III 1985).
5. I.R.C. § 61(a)(3) (1982).
6. I.R.C. § 1001(a) (1982).
7. I.R.C. § 1001(b) (1982), and *see infra* note 39.
8. *See* citations *infra* note 10.
9. I.R.C. § 1012 (1982).

III. Historical Background

A. Introduction

The word "basis" has come to be regarded as a tax term of art whose standard meaning, or at least starting point, is "cost." Originally, "basis" in tax law was not used to refer to cost. Futhermore, an analysis of the statutory development and legislative history reveals that "basis" was intended to have its plain meaning. One will see that the initial use of "basis," as an amount to be subtracted from proceeds, was to prevent rather than accomplish accurate income measurement. It will further be seen that "basis" was intended to be used as a plain word even after being used to refer to cost. It will be shown that the ordinary meaning of "basis" is a more useful way of understanding the word as used today. A detailed analysis of the early statutory uses, otherwise seemingly unrelated, will be necessary to accomplish these objectives.

B. Early Revenue Acts

The notion that basis means cost has a long and respectable history.[10] As early as the Revenue Act of 1918, the general rule concerning property

10. The notion of basis as cost has been put forth frequently by the commentators. "The basis in this transaction, where the property was acquired by purchase, is the cost of such property." Klein, *supra* note 3, at ¶ 13:4. "For ordinary business chattels or tangible physical property the basis is cost." Klein, *supra* note 3, at ¶ 13:6. "The cost of property is the basis to be used in determining gain or loss from the sale or other disposition thereof . . . ." 3A J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 18.02, at 261 (1977 & Supp. August 1986). "The starting point in the determination of gain or loss on a sale or exchange is the determination of the cost basis of the asset sold or exchanged." PELLARD, LAWYERS' TAX MANUAL 321 (1949). "The fundamental basis is 'cost.' This is not emphasized by the statute because it is deemed so obvious as not to require further treatment." HENDERSON, INTRODUCTION TO INCOME TAXATION § 49, at 192 (2d ed. 1949) (footnotes omitted). "The general rule for determining the basis of property is that the basis is cost." Kohn, *Fair Market Value Concept, VI, Basis Problems Affected By Fair Market Value*, 14 CASE W. RES. 214, 214 (1963) (footnotes omitted). "It is fundamental that the gain or loss is always determined by the difference between the 'tax basis or cost,' and the proceeds or 'amount realized.' " Comment, *Crane's Basis: A Reappraisal of the Crane Decision and Its Effect on the Concept of Basis*, 11 VILL. L. REV. 139, 139-40 (1965) (footnotes omitted). "Cost is most commonly used as the basis of a taxpayer's property because most property is acquired by purchase or in a taxable exchange." W. DICKERSON & L. STONE, FEDERAL INCOME TAX FUNDAMENTALS 8-2 (2d ed. 1966). "The basis of property acquired by purchase is its cost." G. ROBINSON, FEDERAL INCOME TAXATION OF REAL ESTATE ¶ 11.02[1] (4th ed. 1984) (citing I.R.C. § 1012). In 1986, Mertens Law of Federal Income Taxation, the secondary authority cited most often by the Tax Court, still said: "The cost of property is the basis to be used in determining gain or loss from the sale or other disposition thereof . . . ." 3A J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 21.02 (1977 & Supp. August 1986). *But see* Kohl, *The Identification Theory of Basis*, 40 TAX L. REV. 623 (1985).

provided that "the basis shall be . . . the cost thereof,"[11] expressed statutorily then almost the same as today.[12] The relevant legislative history[13] was phrased the same as the 1918 statute without elaboration upon the meaning of cost.

The sixteenth amendment to the United States Constitution failed to provide a formula for income calculation. It simply read: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."[14] The sixteenth amendment contained no mention of basis or of cost.

The initial language in the Revenue Act of 1913 substantially tracked the constitutional phraseology:[15] "That there shall be levied, assessed, collected and paid annually upon the entire net income . . . ."[16] The 1913 Act detailed numerous items to be included in income and contained language of deduction, but included no analytical language at an abstract level explicating the meaning of the word "income."

The word "basis" appears three times in the 1913 Act.[17] By themselves these uses might seem completely innocuous. Comparison of these three uses in the 1913 Act with the use of the word "basis" as a subtraction amount will reveal that the word was used in the same ordinary way in all four instances. The first of three instances in the 1913 Act appeared in a section providing for various inclusions, exclusions and deductions.[18] This section explained how nonresidents were to be taxed on their "net income

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11. Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1060 (1919).

12. I.R.C. § 1012 (1982).

13. H.R. Rep. No. 767, 65th Cong., 2d Sess. 4 (1918).

14. U.S. Const. amend. XVI. Great effort went into passage of the sixteenth amendment. As the House Ways and Means Committee put it:

> For 25 years a contest has been waged throughout the country in behalf of the adoption of a national income tax as a permanent part of our fiscal system, and the sentiment in favor of this movement finally became so strong that the people overturned a decision of the Supreme Court of the United States by writing into the Constitution the first amendment within 40 years.

H.R. Rep. No. 5, 63d Cong., 1st Sess., at 36-37 (1913) *quoted in* J. Seidman, Seidman's Legislative History of Federal Income Tax Laws 1938-1861, at 983 (1938). Formal proclamation of ratification occurred on February 25, 1913, and the income tax system that has continued uninterrupted although not unchanged to the present time became effective the next day, March 1, 1913. As to effective date, *see infra* note 15.

15. Not all tax acts were then called reform acts. Although the Revenue Act of 1913 became effective as of March 1, 1913 (ch. 16, 38 Stat. 114, 203 (1913)), it did not become law until October 3 of that year (ch. 16, § 2, 38 Stat. 166, 168 (1913)). The first post-amendment revenue act applied retroactively by seven months.

16. Seidman, *supra* note 14, at 983, *citing to* Revenue Act of 1913, ch. 16, 38 Stat. 114.

17. Revenue Act of 1913, ch. 16, § 2, 38 Stat. 166, 167-74.

18. *Id.* at 167-68.

from property owned and business carried on in the United States."[19] In saying that their income from these sources was to be "computed upon the *basis* prescribed in this paragraph"[20] the statute simply meant that the income was to be computed *in the manner* prescribed. The word "basis" was used in a perfectly ordinary way and with a plain meaning. The word was *not* used to refer to a particular negative item, or item of subtraction.

The second and third instances of the appearance of the word "basis" in the 1913 Act were close to one another both spacially and connotatively. "Basis" was used to determine whether a chosen fiscal year or the calendar year was the appropriate taxable year for certain non-individual taxpaying entities. The language was that the tax due was to be "computed upon the *basis* of the net income" of a fiscal year "instead of upon the *basis* of the net income" for a calendar year.[21] Clearly, in the second and third instances, "basis" again was intended to retain its plain meaning. The word was not used to refer to a subtraction amount but rather to the whole income.

In these two instances, "basis" was used to refer to an item in a mathematical calculation just as it is today, even if the particular item is not the same item as today. The word "basis" simply refers to the *base on which* calculation is to be made. *The tax is to be computed on the basis of the income.* The particular mathematical calculation happens to be multiplication. The income is multiplied by the tax rate to determine the tax due. "Basis" is being used to refer to the multiplicand rather than to the subtrahend. The parallel today would be to say *the income is to be computed on the basis of the cost.*

The first use of the word "basis" to refer to a subtraction amount appeared in the Revenue Act of 1916. The language provided that for purposes of calculating gain derived from the sale or other disposition of prop-

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19. *Id.* at 168.

20. *Id.* at 168, 174 (emphasis added). The context was that income from these sources was to be "computed upon the *basis* prescribed in this paragraph and that part of paragraph G of this section relating to the computation of the net income of corporations, joint-stock and insurance companies, organized, created, or existing under the laws of foreign countries, in so far as applicable." *Id.* (emphasis added).

21. *Id.* at 174 (emphasis added to the word "basis"). The context can be seen in the following language:

> *Provided further*, That any corporation, joint-stock company or association, or insurance company subject to this tax may designate the last day of any month in the year as the day of the closing of its fiscal year and shall be entitled to have the tax payable by it computed upon the *basis* of the net income ascertained as herein provided for the year ending on the day so designated in the year preceding the date of assessment instead of upon the *basis* of the net income for the calendar year preceding the date of assessment . . . .

Id. (emphasis added to the word "basis").

erty acquired before March 1, 1913, the fair market value of the property shall be the basis.[22] This first use of the word "basis" to designate an amount to be subtracted in the calculation of income for purposes of its taxation was intended to *prevent* the accurate measurement of income and thereby to avoid its taxation.

While such distortion of income may be generally blameworthy, those who enacted this particular provision were operating under an arguable constraint whose force they apparently felt was compelling. Before enactment of the 1916 amendment, taxation of income in the manner of the 1913 Act was thought unconstitutional.[23] Therefore, if property acquired before passage of the amendment increased in value both before and after passage and then was sold, it was thought that only the gain accruing after passage was within the reach of the tax.

The way chosen to achieve taxation of the desired amount was to provide for subtraction of the March 1, 1913, value from revenue. Although the resulting amount would be only part of the income, it was the only part that could be taxed. Obviously, the focus of concern was the amount to be subtracted because that was the amount that was altered. Thus, the amount to be subtracted was the foundation on which permissibly taxable income would be built by further appreciation in value. The March 1, 1913, value formed the *base from which* permissibly taxable income would be measured. Income was to be computed *on the basis of* March 1, 1913, value.

The word "basis" in the 1916 Act was used in an ordinary way and had a meaning every bit as plain as the three 1913 uses of the word. Likewise, this ordinary use and plain meaning of basis mirrored the three instances of "basis" in the 1913 Act. Noteworthy, however, is the fact that *none* of these four uses pertained to cost. The word "cost" was not used in association with the word "basis," and the meaning "cost" was not intended.[24]

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22. The exact language is as follows:

For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the *basis* for determining the amount of such gain derived . . . .

Revenue Act of 1916, ch. 463, § 2(c), 39 Stat. 756 (emphasis added). The years 1914 and 1915 came and passed without Revenue Acts. An effort to prove the negative is very difficult in historical research, and the text claim concerning the first use of the word "basis" is no exception. Suggestions as to earlier uses of the word would be welcomed.

23. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 513 (1895).

24. An effort was made to place an alternative use in the 1916 Act as a substitute for the language which passed. J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, at 957-58 (1938). The alternative referred to the measure of income itself, the multiplicand again, in the calculation of taxes due, but also sought to distort

The similarity of the ways in which "basis" was used to refer to a variety of things creates a strong impression that the word was not being used in a special way, even though "basis" as a subtraction amount had already been introduced as the fourth use. This impression is reinforced by the Senate Finance Committee Report associated with the successfully enacted basis-as-1913-value language of the 1916 Act, which refers not to "*the* basis," but to "*a* basis."[25] The use is casual.

Of the various parts of the two formulas necessary for calculating income and computing the tax, the subtraction amount in income calculation was the focus of concern because of the March 1, 1913, transition problems. As soon as reference is made to the subtraction amount in calculation of income from sale of property acquired in the pre-amendment period, the usefulness of making reference to the subtraction amount for property acquired after passage is suggested. Only in the Revenue Act of 1918 did Congress for the first time bother stating statutorily what otherwise seemed obvious, and apparently only did so because of the 1913 transition problems.

Using language paralleling the language of two years earlier in the 1916 Act for the special subtraction amount, Congress adopted the following language in the Revenue Act of 1918:

> Sec. 202(a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the *basis* shall be —
>
> (1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and
>
> (2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.[26]

The formality of present drafting structure was present, including its economy of words. The word "basis" was used to refer to two different subtraction amounts even though, unlike the two parallel uses in the 1913 Act, the word appeared only once. The general (*i.e.*, first stated) rule of basis in the 1918 Act was the March 1, 1913, value, since so much of the property

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income (i.e., prevent its accurate measurement). The alternative was not enacted, but in it, too, the usage was ordinary and the meaning plain.

25. S. REP. NO. 793, 64th Cong., 1st Sess. (1916) (emphasis added).

> The committee amendment fixes as a *basis* for ascertaining the gains and losses from the sale and other disposition of property, real (sic) personal, and mixed, acquired before March 1, 1913, the fair market value of such property as of March 1, 1913.

Id. (emphasis added).

26. Revenue Act of 1918, ch. 18, § 202, 40 Stat. 1057, 1060 (1919) (emphasis added).

extant in 1918 had been purchased before passage of the amendment.[27] But the 1918 Act used the formulation that would become commonplace — "the basis shall be . . . the cost thereof."[28] These words have echoed ever since.

C. *Even Realty Co.*

The impression that the word "basis" was intended to have its normal meaning is further reinforced by the opinion in *Even Realty Co.*[29] Written in 1925, nearly contemporaneously with the developments at issue, and leaning on contemporaneous dictionaries, Judge Ivins had a vantage hard to recapture. Citing the new American Encyclopedic Dictionary and Webster's New International Dictionary, Judge Ivins explained that Congress intended the word "basis" to convey its commonly accepted meaning. He further stated that Congress expected basis to serve as a starting point in a computation leading to a logical measure of gain or loss. "Basis" was chosen merely to take account of the differing circumstances created when property disposed of was acquired before or after March 1, 1913.[30]

One can see that the court was looking toward adjustments being made to basis *before* subtracting basis from revenue. The court was not looking

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27. This general rule has since been reduced to the position of a less common, indeed rare, exception.

28. H.R. 14198, 66th Cong., 2d Sess., § 1 (1920).

29. *In re* Even Realty Co., 1 B.T.A. 355 (1925).

30. *Id.* at 357-58.

> There is no ground for believing that Congress, in using the word 'basis' intended it to carry any other than its commonly accepted meaning. The New American Encyclopedic Dictionary defines 'basis' as follows:
>
> A. *Ordinary language*
>
> I. *Lit. Of things which are or are assumed to be material*: That on which anything rests or is supposed to rest; the lowest part of anything, as the foundation of a building, etc.
>
> II. *Of things immaterial*: The fundamental principle, groundwork, or support of anything.

Id.

Webster's New International Dictionary says:

> *Basis*: 1. The foundation of anything; that on which a things rests; the base. . . . 4. The principal component part of a thing. 5. The groundwork; the first or fundamental principle; that which supports or sustains.
>
> We have no hesitation in holding that Congress in using the word *basis* meant nothing but *starting point* or *primary figure* in the computation of gain or loss, and had no intention of restricting that computation to a simple subtraction of the basis from the selling price or vice versa. It expected the computation to include all adjustments necessary to a logical ascertainment of gain or loss. The only reason for using the word at all was to take care of the different situation arising when the property disposed of had been acquired *(a)* before and *(b)* on or after March 1, 1913.

Id.

toward the revenue itself when it spoke of basis as the "*starting point* or *primary figure*."[31] Nevertheless, the word "basis" referred to was the same word in the same place in the same statute that was being interpreted before the reference above to the *Even Realty Co.* case. "Basis" had its plain meaning. And the court hit the nail on the head when it said the "only reason for using the word at all was to take care of"[32] the March 1, 1913, funny business.

IV. Transaction Types

Selected transactions will be used to demonstrate the theory of basis presented in this article. The breakdown of transactions categorizes them according to whether cash or noncash property or both are involved; whether the values exchanged are equal or unequal; and whether the transaction is a recognition event. The examples chosen are drawn from that portion of the field sufficiently general in applicability to be known simply as income taxation, but which many will recognize as individual income taxation. The method with which gain is calculated and the manner in which basis operates in each transaction will be explained as background for reaching conclusions about the system of basis.

A. *Purchase*

The purchase of noncash property for cash is the classic paradigm commonly used for explanation of basis. This paradigm is fortunate since this situation involves a common, easily understood transaction in which all students of taxation have engaged before commencing their inquiry into this arcane discipline. In a cash purchase the meaning of basis as cost can readily be seen. Limited discussion of a subsequent sale will be immediately necessary, however, because only then does the significance of basis established on purchase become apparent.

If *A* purchases candlesticks for $40 and sells them for $100, it is evident that *A* has a gain of $60. Obviously, the reason being that *A* received $60 more than the *cost*. Under I.R.C. § 1012,[33] the basis in the candlesticks was their cost. Since the word "basis" as used today would normally be considered a tax term of art and since the Code defines the term using an ordinary word, "cost," one is entitled to expect as a simple matter of statutory construction that the word "cost" will be given its ordinary meaning. If the word "basis" is read in its historical sense as simply a plain word used in an ordinary way, then revelation of what is to be subtracted still turns

31. *In re* Even Realty Co., 1 B.T.A. at 358.
32. *Id.* at 358.
33. I.R.C. § 1012 (1982).

wholly on the word "cost," a plain word which should still, therefore, retain its plain meaning. The cost of an item consists of the value given to obtain the item.[34] This ordinary meaning is, in fact, what was intended. Its application reveals that A's basis in the candlesticks is $40.

Under I.R.C. § 1001(a)[35] the gain from sale of the candlesticks consists of the excess of the amount realized over the basis. Pursuant to I.R.C. § 1001(b),[36] the amount realized comprises the sum of money received, $100, plus the fair market value of any noncash property received, here $0, for a total amount realized of $100. The difference amounts to $60. The Code's laborious approach confirms what was intuitively obvious. The basis in the candlesticks was established in such an amount so that income would be accurately measured and taxed. For those who like rules to remember, the Code provides one: basis means cost.

B. Property Exchange

If the candlesticks purchased in the immediately preceding example were exchanged for other noncash property, say 100 loaves of bread valued at $1 per loaf, a very similar analysis would follow.[37] Under I.R.C. § 1001(b)[38] the amount realized consists of the sum of money received, here $0, plus the fair market value of the noncash property received, now $100. A different part of I.R.C. § 1001(b) has been brought into play, but the total amount realized remains $100.[39]

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34. *See generally*, Comment, *Crane's Basis: A Reappraisal of the* Crane *Decision And Its Effect On The Concept Of Basis*, 11 VILL. L. REV. 139 (1965); Wurzel, *The Tax Basis for Assorted Bargain Purchases or: The Inordinate Cost of 'Ersatz' Legislation*, 20 TAX L. REV. 165 (1964). "[C]ost . . . 1 a: the amount or equivalent paid or given or charged or engaged to be paid or given for anything bought or taken in barter or for service rendered: CHARGE, PRICE b: whatever must be given, sacrificed, suffered, or foregone to secure a benefit or accomplish a result." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 601 (1961). *See also* A. PARKER, E. KRADER, S. LEIMBERG, M. SATINSKY, STANLEY & KILCULLEN'S FEDERAL INCOME TAX LAW 13-12 (1983).

35. I.R.C. § 1001(a) (1982).

36. I.R.C. § 1001(b) (1982).

37. An exchange of one commodity for another results in income received. Treas. Reg. § 1.61-4(c) (1987). The exchange of a painting for the use of an apartment resulted in taxable income. Rev. Rul. 79-24, 1979-1 C.B. 60. *See* Internal Revenue Manual - Audit, § 4232(12) (Dec. 6, 1983).

38. I.R.C. § 1001(b) (1982).

39. Life can be seen in the Code as the significance of the self-adjusting mechanisms of § 1001(h) becomes apparent. The sum of money received as a component of amount realized, $100 in the prior example, is in this example reduced to $0. While the rule is still present and operating, it lacks significance here. Conversely, the fair market value of noncash property received as a component of amount realized, previously lacking significance, now becomes important.

The significant similarity to the downstream disposition by sale in the preceding purchase example lies in the fact that the *amount* realized was the same because the *values* realized

The basis of the candlesticks will still equal their cost, or $40, under I.R.C. § 1012.[40] The gain from disposition of the candlesticks will once again equal the excess of the amount realized, or $100, over the basis in the candlesticks, for the same difference or gain of $60.

With income properly measured, thereby creating the opportunity for its taxation, basis has once again played its role in the tax system. Basis in the candlesticks was established and was used to measure gain in a subsequent exchange of those candlesticks. Basis meant cost, which again meant the value given.

The principal transaction discussed in the purchase example was the purchase itself, where basis in the property *received* by purchase was addressed. The property *received* in the present barter exchange must also be given a basis, for it also could be sold. If the loaves of bread were sold for $110, for instance, then some amount must be subtracted to derive the gain, if any. *A* entered into the initial purchase transaction with $40, and now has $110. Clearly, *A*'s gain in between is $70. But *A* had gain of $60 in the intervening exchange of the candlesticks for the loaves of bread. Therefore, only $10 remains to be recognized. Since the amount realized is $110, only a basis of $100 can be assigned to produce the correct gain of $10. Although *A* acquired the candlesticks with a basis of $40, *A*'s basis in the loaves became $100 because *A* recognized $60 gain on their acquisition. Only by granting a new basis of $60 in the loaves can the $60 of gain they represent be protected from taxation a second time. The $40 initial basis in the candlesticks carries through to the loaves. When the new basis of $60 is added, the total basis in the loaves becomes $100. An important and established point is that basis increases for gain recognized.

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were the same, value being the significant aspect of amount realized. The form in which the value is received is irrelevant. The fact that the Code breaks down what is received beckons interest since the breakdown is wholly unnecessary. The words "the sum of any money received" as a component of amount realized reflects the artificiality of the breakdown since only the *value* of the money received is relevant; but a *focus* in the statutory language on this fact is lacking when these words are juxtaposed against the words used to identify the other constituent element: "the fair market value of the property (other than money) received." I.R.C. § 1001(b) (1982). The full phrase "the sum of any money received plus *the fair market value of the property* (other than money) *received*" has the same meaning as if only the italicized words were present.

The validity of the phrase as written, and the identity of meaning suggested, turns on the element inherent in legal tender that the sum of money equals the fair market value of the money. This is definitional. The peculiar equalities of certain aspects of money when numerically expressed, and the significance for the theory of basis presented, will be addressed later.

Not only does this second example, as already stated, bring a different part of I.R.C. § 1001(b) into play, it also triggers a different part of I.R.C. § 1001(a): it falls not under "sale," but under "or other disposition" of property. The example thereby makes the important point that in the normal case people will not be able to barter their way out of the tax system.

40. I.R.C. § 1012 (1982).

In the above discussion of the $40 basis in the candlesticks in the initial purchase example, basis appeared to mean cost. Here basis appears to mean prior basis plus gain recognized (with prior basis still explained by initial cost). If two rules are necessary, each one to explain one of the two situations, then a conceptual unity of principle in basis theory is lacking. But two rules are not necessary here, for each will work in both situations. The rule of the second situation would work in the first situation. When the candlesticks were purchased for $40, their basis could be said to be cost plus gain recognized in the transaction. The resulting basis was $40 because the quantity of gain recognized in the transaction was $0. Similarly, the rule of the first situation would work in the second situation. When the loaves of bread were acquired at a cost of 100 candlesticks,[41] the cost of the loaves expressed in dollars equals the value of $100 of the candlesticks, resulting in a basis in the loaves of $100.

As between two rules that work, the simpler one is preferred on mere aesthetic grounds. The simpler rule is more likely to produce conceptual harmony, as well as the genuine understanding of principled unity from which, of course, conceptual elegance flows. The two-step rule providing that basis means prior basis plus gain recognized retains usefulness for the insight provided. But the one-step rule that basis means cost continues to work quite well.

C. *Property Exchange — Unequal Values*

The common thought that the value given in a transaction equals the value received went without saying in the prior two examples, but it is respectfully suggested that this thought is a myth.

1. He-Man

A He-Man[42] is a small figurine currently in favor with the two-to-seven-year-old set. A child in this age range would readily part with $10, or more I fear, to obtain the genuine article and not a cheap substitute. I have never observed this transformed Prince Adam[43] for sale at a price that was not below $5.00. It is possible to make the purchase for $3.59 or for $4.95, and probably for a good many prices in between, although it might have been supposed that the same item cannot have two different values in the

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41. *See* J. COMMONS, LEGAL FOUNDATIONS OF CAPITALISM 380 (1968).

42. He-Man, most powerful man in the universe, is part of Mattel's Master's of the Universe™ collection. All rights are reserved by Mattel. One recent price for this item was $4.42.

43. Prince Adam, Prince of Eternia, is part of Mattel's Master's of the Universe™ collection. All rights are reserved by Mattel. Prince Adam is to He-Man as Clark Kent is to Superman.

same town and certainly not in the same store. While my sampling of prices is admittedly limited geographically and not subject to valid statistical projection, I do not doubt that this item, when in stock, commonly can be found for sale marked with different prices in the same town and sometimes in the same store. If the item has more than one value, then it would be meaningless to speak of *the* value of the item.

If value means whatever an item sells for, then the fact that it sells for different amounts provides evidence of differing values. When one speaks of an item's value, one must be perceived to mean a transaction-specific value, however unconscious of this meaning one normally is. This fact of course admits the proposition that beyond the transaction-specific meaning, it *is* meaningless to speak of an item's value. Yet it is common to speak of an item's value and to intend reference to a more generic value. This generic use of value makes sense when considered to refer to a point estimate or to a reasonable value range within which the item is normally found to change hands.[44] Yet even the store that sells a He-Man at only one marked price and never has a special sale price, ordinarily has at least two prices. One is the price at which the item was bought by the store, certainly a fair measure of its value, and the other the price at retail, another fair measure of its value.

Furthermore, in a retail transaction in which an adult pays $4.95 for a He-Man, presumably as a gift, he or she does so only because the item is worth *more* to that person than the $4.95 given up. If this were not so, the person would not bother making the purchase. At the *same time*, the store considers the *same item* to be worth *less* to the store than $4.95. If this were not so, the store would have no interest in selling the item.[45]

Therefore, when one speaks of the value of an object at the time of its purchase as being the purchase price, this conclusion is really only a convention, albeit a useful convention.[46] It is not commonly true that an object is worth exactly what is paid for it, neither more nor less. Any certainty with which one speaks of the value of an object, or says that the values exchanged are equal, may be even less when cash is not involved on either side of the transaction, as we shall see.

44. *See* J. COMMONS, LEGAL FOUNDATIONS OF CAPITALISM 8-9, 211 (1968).

45. I won't go into my views on the price of Battle Cat, a beast necessary to the proper transportation of He-Man. Battle Cat, Fighting Tiger, is part of Mattel's Master's of the Universe Collection.™ All rights are reserved by Mattel. One recent price for this item was $7.57.

46. *See* Oxford Paper Co. v. United States, 86 F. Supp. 366 (S.D.N.Y. 1949); Carl Britt, 43 B.T.A. 254 (1941); Hugh Matheson, 31 B.T.A. 493 (1934), *aff'd* 82 F.2d 380 (5th Cir. 1936); J. KLEIN, FEDERAL INCOME TAXATION ¶ 26:7 (1929).

2. *Philadelphia Park Amusement Co. v. United States*

Philadelphia Park Amusement Co. v. United States[47] presents a case in point. This opinion, written by Judge Laramore, for the United States Court of Claims, is possibly the most delightful tax decision extant. The facts, indeed the alternative facts, contemplated in the case provide the occasion for perceptions of United States tax law from angles that might otherwise be missed.

The taxpayer, Philadelphia Park Amusement Company, owned an amusement park on one side of the Schuylkill River.[48] Many patrons of the amusement park lived on the other side of the river.[49] Accordingly, the taxpayer (through its predecessor) arranged for transportation.[50] On July 6, 1889, a 50-year franchise "to construct, operate, and maintain" a "passenger railway" was obtained by the taxpayer from the City of Philadelphia.[51] Pursuant to this franchise, Strawberry Bridge was constructed across the Schuylkill River "at a cost of $381,000."[52] As the case put it, at the end of the 50-year term, the franchise would continue indefinitely for 10 year terms unless the City provided one year notice of its desire to terminate. If termination did in fact occur, the franchise agreement gave the City the right to purchase all of the improvements that had been built.[53] At the time

47. Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

48. *Id.* at 186.

49. *Id.*

50. *Id.* at 185.

51. *Id.*

52. *Id.* at 185-86.

53. Upon the expiration of the 50-year term the franchise was to continue indefinitely for additional successive 10-year terms unless the City gave one year's written notice of its wish to terminate . . . . Upon the termination of the license the City had the right to purchase all, but not just part of, the improvements; *i.e.* railway cars, tracks, bridges, buildings, etc., made by the licensee at the cash value at the time of purchase, or in the event the City did not desire to purchase the assets the licensee had a specified period of time within which to remove them.

Id. at 185.

The bridge and the taxpayer's problem are both described in the case as follows:

The bridge was 79 ½ feet wide and carried pedestrian and vehicular traffic in addition to taxpayer's streetcars. The taxpayer's principal business was the operation of an amusement park and the street railway was employed in the transportation of customers to the park. With the increase in automobile transportation the proportion of customers carried to the amusement park by the taxpayer's streetcars decreased over the years and during the latter years of its operation losses were sustained. Early in 1934 the City, in writing the taxpayer, pointed out that Strawberry Bridge was in need of extensive repairs, that it was taxpayer's obligation to make the repairs at taxpayer's expense, and threatened to close the bridge unless the repairs were made promptly. The taxpayer wrote the City explaining that its financial condition prevented the making of extensive repairs to the bridge and offered to transfer the ownership of the bridge to the City in exchange for a of the exchange, the undepreciated cost of the bridge was $228,852.74.[54] The unamortized cost of the original franchise was $50,000.[55] It is of some interest, although the case does not discuss it, that the sixteenth amendment was ratified while the facts in this case were in progress.[56] It was not economically worthwhile for the taxpayer to fix the bridge, nor did the taxpayer seem to have the finances to do so.[57] This was the first 10-year extension, and it was being made a few years early.[58]

As to Strawberry Bridge, the taxpayer took the position that the bridge had *no* value.[59] As to the railway franchise, the taxpayer in fact abandoned it in 1946,[60] three years before expiration of the extension in question.[61] Alternatively, the taxpayer contended that the bridge and the extension were not really exchanged for each other.[62] On the face of the decision these positions are reasonable, although debatable. The bridge needed extensive repairs that the taxpayer was required to make if it wished to keep the bridge and avoid closure of the bridge by the city.

The effect on the taxpayer's calculations of the possibility that a mere four years later the city might decline to extend the franchise and require taxpayer to remove the bridge can only be imagined. For either reason, and certainly for both, the taxpayer could have felt powerful economic incentive to part with the bridge, even if parting meant simply giving the bridge to the city at no charge and for no extension. The possibility that property might reasonably be considered more burden than benefit, having negative value, is not far fetched. At the very least, one might be better off having one's bridge accessible and repaired for free than having to pay for the

> 10-year extension of the railway franchise. The City accepted the offer and on August 3, 1934, Strawberry Bridge was transferred to the City. The taxpayer reserved its right-of-way over the bridge for the duration of its franchise and agreed to maintain its facilities thereon. On November 14, 1934, the City amended the franchise and extended it from July 24, 1939, to July 24, 1949.

Id. at 186.

54. *Id.*

55. *Id.*

56. *Id.* at 185-86.

57. *Id.* at 186. What the taxpayer would have done if the City had said "no" to the exchange proposal is speculative. The City's decision regarding how to proceed could have been affected by the taxpayer's financial difficulty. Although speculative, the taxpayer might have had a reasonable expectation of receiving the 10-year extension of the railway franchise even if there had been no bridge problems and the taxpayer had kept the bridge.

58. But while the City might have expected no payment for an extension made in due course, payment was made for the original grant of 50 years and might have been required here. *Id.* at 187. Of course the benefit to the public of having the railway continue operating might have provided sufficient reason for the City to allow the extension.

59. *Id.*

60. *Id.* at 186

61. *Id.*

62. *Id.* at 187.

repairs. The court disagreed, believing "that the bridge had some value, and that the contract under which the bridge was transferred to the City clearly indicates that the one was given in consideration for the other."[63]

Regardless, the exact values of the properties exchanged were in doubt and the court declined to find the values. The court even declined to find that the values were equal. Instead, the court contemplated both the possibility that the values were equal and the possibility that they were unequal. It remanded to the Commissioner of the court for fact finding on this point.[64] No further published judicial report followed.

In discussion of the possibility that the values exchanged were unequal, the court noted two conflicting views of what constitutes the cost of property received in a property exchange. One view states that the fair market value of the property *given* makes up basis while another suggests the fair market value of the property *received* is the cost basis in the property.[65]

In the normal exchange, or rather in the way we normally think about an exchange, resolution of whether "cost basis" means value given or value received will matter only for purposes of understanding what is happening. The resolution will not affect the dollar answer. The dollar answer will be the same regardless of the resolution precisely because the values given and received are the same, or rather are thought to be the same. If the cost of the property received in a taxable exchange is interpreted to mean value received, rather than value given, *and if value received and value given are the same*, then one can reach the right answer to the question "What is the basis?" by looking in the wrong place, at value given. The answer would be right, by accident. The accident is that the values are equal. Indeed, only a fact pattern not normally contemplated, that the values are unequal, can force the issue.

Interpretation of the word "cost," as in "cost of candlesticks," to mean the value of the candlesticks rather than the value of cash given for the candlesticks is odd statutory construction. Acceptance of this interpretation should depend on strong arguments.

Philadelphia Park does not offer a detailed argument. Instead, it offers

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63. *Id.*

64. *Id.* at 190.

65. The succinct statement in section 113(a) [of the 1939 Code] that 'the basis of property shall be the cost of such property' although clear in principle, is frequently difficult in application. One view is that the cost basis of property received in a taxable exchange is the fair market value of the property *given* in the exchange. The other view is that the cost basis of property received in a taxable exchange is the fair market value of the property *received* in the exchange. As will be seen . . . the Commissioner's position has not been altogether consistent on this question.

Id. at 188.

the following general language:

> When property is exchanged for property in a taxable exchange the taxpayer is taxed on the difference between the adjusted basis of the property given in exchange and the fair market value of the property received in exchange. For purposes of determining gain or loss the fair market value of the property received is treated as cash and taxed accordingly. To maintain harmony with the fundamental purpose of these sections, it is necessary to consider the fair market value of the property received as the cost basis to the taxpayer. The failure to do so would result in allowing the taxpayer a stepped-up basis, without paying a tax therefore, if the fair market value of the property received is less than the fair market value of the property given, and the taxpayer would be subjected to a double tax if the fair market value of the property received is more than the fair market value of the property given. By holding that the fair market value of the property received in a taxable exchange is the cost basis, the above discrepancy is avoided and the basis of the property received will equal the adjusted basis of the property given plus any gain recognized, or that should have been recognized, or minus any loss recognized, or that should have been recognized.[66]

The above explanation suffices to justify the important contribution this case makes to the law, but the explanation rises to a level of abstraction that does not invite all to follow. An example may help to clarify the reasoning of *Philadelphia Park.*

The properties in this example are not equal in value. The transaction constitutes a recognition event.[67] Suppose *A* exchanges property *X* with *B* for property *Y*. *A*'s basis in property *X* before the exchange is $40, being the amount *A* paid for *X* in cash. *B*'s basis in property *Y* before the exchange is $75, for the same reason. At the time of exchange, property *X* is worth $100 and property *Y* is worth $110. *A* and *B* are not related to each other and they are not friends. *A* simply is making a good deal. Property *X* is worth $100 and property *Y* is worth $110, *by hypothesis.*

At the time of the exchange, *A* realizes and recognizes a gain. The quantity of *A*'s gain is the amount *A* realizes minus *A*'s basis in the property given. That the relevant basis in the measure of this gain is the basis of the property *given* is clear from the interaction of sections 1001(a)[68] and

66. *Id.* 188-89.

67. *See* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1964). This example is not from the case.

68. I.R.C. § 1001(a) (1982).

section 1012.[69] *But it is equally clear from I.R.C. § 1001(b),*[70] *and here is an important touchstone for what follows, that the relevant amount realized is the value of the property received.* Viewed from the perspective of *A*, one aspect of the property *received* is relevant, its value. The basis *B* had in that property, property *Y*, is completely irrelevant to analysis of the quantity of gain to be recognized by *A*. Still viewed from the perspective of *A*, one aspect of the property *given* is relevant, its basis. *The value of the property given is irrelevant to analysis of the quantity of gain to be recognized by A.* If this were not so, when the conventional assumption of equality of values exchanged is considered to be operating, no one would ever have gain from a property exchange. The amount realized and the value parted with would always be the same.

Both figures — the value of the property received and the basis of the property given — are known. The amount realized of $110 exceeds basis of $40 by the amount of gain, which is $70. Because the difference between *these* figures measures the income to be recognized, one *must* look to the difference between *these* figures to measure the amount of basis increase necessary to prevent recognition of that same amount of income a second time.

A now possesses property *Y*. The focus of the discussion in the purchase example above was on determination of the basis of the property received. In the property exchange example, the ultimate focus also was on the basis of the property received. Here, too, the critical mechanical step is determination of *A*'s basis in *Y*. An interpretation of basis as cost and an interpretation of cost in accordance with the actual meaning of the word in the language, value given, would lead to the conclusion that *A*'s basis in property *Y* is $100. What consequences would flow from that conclusion?

Suppose *A* sold the newly acquired property *Y* immediately after its acquisition for its value. *A*'s amount realized would be $110 and *A*'s basis would be $100. *A* would be required to recognize a gain of $10 as income. But did *A* have any gain?

A's built-in untaxed gain in property *X*, due to appreciation of the property, was $60. Because *A* made a good deal in the exchange, *A*'s total gain realized was increased to $70. And that is the amount recognized by *A* in the exchange in which *A* acquired property *Y*. Once *A* has recognized all the gain present in the transaction, no more gain exists to be recognized unless property *Y* increases in value or *A* makes another good deal. Assuming that neither occurs, then a sale by *A* of property *Y* would be at its value of $110. In this case, *A* would nevertheless recognize gain of $10 *if A*'s

69. I.R.C. § 1012 (1982).
70. I.R.C. § 1001(b) (1982).

basis in property *Y* were the value given for property *Y*, $100.

One way to explain this result is that *A* would have recognized gain that does not exist. Another way to reason suggests that *A* would have recognized the same gain twice. In the exchange in which property *Y* was acquired, *A* recognized all $70 of the gain. On immediate resale, *A* recognized $10 of *that* gain a second time. Gain of $80 would be taxed when only $70 gain existed, thereby frustrating both purposes of the income tax system. First, total income would not have been accurately measured and second, some income would consequently have been taxed more than once. So cost cannot be interpreted to mean value given, although that is precisely what the word means, and, therefore, basis does not mean cost on these facts.

The quantity of gain that would have been recognized twice was $10. This may fairly be thought to be the *top* $10 of gain out of the total actual gain of $70. This is not arbitrary, for the very failure to increase basis for the *top* $10 of the first $70 of gain recognized led to recognition of precisely that gain (and not some other $10 of the remaining $60 of gain) a second time.

This reflects the idea that basis must be increased for gain recognized if double taxation of that gain is to be prevented. In connection with the top $10 of gain, this notion has a significance that it lacks in connection with the first, or bottom, $60 of gain, however. As to the first $60 of gain, *A*'s basis in the received property *Y* increases by $60, an equivalent amount. It also is true, however, that *A* parted with $60 of value in property *X* to get that $60 of value in property *Y*. Therefore, *A* may be seen as having paid a cost, in the true sense of the word, for the property. Only as to the $10 of value received *above* value given does recognition of gain *without* value given occur.

The statement that basis can and does increase for gain recognized is not a novelty. In the typical case, however, or rather the case as one typically thinks about it, value parted with can also be found, just as it was here (as to the $60). Therefore, only the situation of unequal values exchanged allows the unusual insight that recognition *without value given* justifies basis.

The full basis of *A* in property *Y* when received, however, is $110. It is not just the $60 or even the $70. The full basis is made up of the $40 of prior basis, in property *X*, which detaches from property *X* and attaches to property *Y*, but for which $40 of value is also given; plus $60 for gain recognized or alternatively for value given; plus $10 for which recognition is the *only* possible explanation.

While the $40 and $60 of basis thus each have alternative potential explanations, they have in common the value given (cost) as a potential explanation. While the $60 of basis has alternative potential explanations, the $60 and $10 of basis have in common the amount recognized as a potential explanation. These three components, and total basis of $110, may therefore be said to be explained by three alternative two-step basis rules. Basis of $110 is made up of cost (meaning value given) plus any gain recognized for which no cost was paid. So viewed, basis is $100 plus $10, or $110. Alternatively, basis of $110 is made up of value given without gain being recognized plus gain recognized whether or not value was given. So viewed, basis is $40 plus $70, or $110. Of course, the first $40 of value given may also be identified with prior basis, allowing the formulation that basis of $110 in the newly received property is made up of prior basis in the property given, $40, plus gain recognized of $70.

Does this basis of $110, however explained, work? It represents the alternative view of basis contemplated in *Philadelphia Park*:[71] cost means value received, and it will be subjected to the same test.[72] If *A* now resells property *Y* immediately following acquisition for its value at exchange, $110, gain will be the amount realized of $110 less basis of $110 for a difference, or gain, of $0. Since all gain present was recognized on the exchange, gain should be $0 on immediate resale. Since gain is indeed $0 on resale, harmony has been restored. If cost is interpreted to mean value received, the income tax system is once again accomplishing its objectives.[73]

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71. Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1964).

72. *Id.* at 185.

73. What about the other side of a deal in which values exchanged are unequal? What if *A* had made a bad deal? Analyzing the situation in considerably less detail, suppose *A* parted with property *X* worth $100 but received property *Y* worth $90, and the facts are otherwise the same. *A*'s gain is amount realized of $90 minus basis of $40, for gain of $50. If basis means value given, then *A*'s basis in property *Y* is $100. Ten dollars of this basis, again the top $10, is basis for which *A* neither parted with prior basis nor paid value nor recognized gain. If *A* sells property *Y* immediately after the exchange for its value of $90, *A* will recognize a loss of $10. This is made up of amount realized of $90, less basis of $100, for a difference or loss of $10.

The top $10 in the prior example was $10 of gain being recognized twice for failure of sufficient basis. The top $10 here, however, is $10 of basis, unwarranted basis and consequently an undeserved sheltering effect, leading to a failure of income recognition.

This can be seen in the following manner. Total gain to be recognized on the exchange was $50. But total gain actually recognized was $50 plus loss of $10 for a net of $40. It is fair to say a loss or deduction of $10 was obtained without any cost being paid. Looking at the net of $40, it is fair to say that $10 of gain was not effectually recognized (due to the cancellation of its recognition). Should there be a delay to a subsequent tax period for recognition of the loss (to a tax period subsequent to recognition of the gain), then the loss will offset different income.

The total income, as a result of the two transactions, $50 gain and $10 loss will remain a net gain of $40. Both purposes of the income tax system would thereby have been frustrated. Total income would not have been accurately measured and some income would consequently have escaped taxation. So cost again cannot be interpreted to mean value given, although that

The three two-step basis rules were necessitated by the failure of the prior one-step basis rule to work in an exchange of properties unequal in value. Reinterpreting cost to mean value received, however, returns to a one-step basis rule whose words are the same as, although different in meaning from, the prior one-step basis rule — basis means cost, meaning value received rather than value given. But value received is *not* the meaning of the word cost, even if that is how the word must be construed to make the rule work.

It is suggested that cost cannot be interpreted to mean value received. The ability to communicate by use of the language is hindered if words are said to mean what they don't mean. One can simply say that basis means value received. Such a statement would accurately express one's meaning with words whose efficacy is not destroyed while retaining the brevity of a one-step expression.

As between the three two-step rules and the one-step rule, a rule with fewer steps is surely to be preferred as easier, especially if it suffers the advantage of working. This one-step basis rule works where values of property are unequal, whereas the prior rule did not. This one-step rule also works in each prior situation that the prior rule could handle — the purchase and the property exchange situations discussed above, when values exchanged were presumed equal.

An analytical framework exists for explaining why value received as basis works and value given does not. The analytical framework which gives it cogency was presented above. Only the *value of the property received* is used in measuring gain — as amount realized — from which is subtracted prior basis. The device that prevents that gain from being taxed more or less than once, basis, must therefore look to this same thing, the *value of the property received*, in order that basis be changed to precisely the correct amount. Since value received is the linchpin with which basis must be compared in calculation of gain, it *must* be the touchstone for calculation of new basis if gain is to be recognized, but only once.

Several rules of basis have been discussed thus far. Each rule has worked if used in the appropriate situation. But only two of the rules thus far discussed would work in all situations so far presented — basis as prior

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is what the word means, and, therefore, basis again does not mean cost on these facts.

But if cost is again interpreted to mean value received, then the nonsensical results are again avoided. Setting basis in property *Y* at the value of property *Y* when received by *A*, preferably, of course, without using the word "cost," instead of setting it at the value of property *X* when given by *A*, the basis of property *Y* after the exchange will be $90. If *A* now sells property *Y* immediately after the exchange for its value of $90, gain will be $0. Total gain to be recognized, it will be recalled, was $50, and this total amount was recognized on the exchange. So gain on immediate subsequent resale at value should be $0. Harmony has again been restored.

basis plus gain recognized, and basis as value received. Always preferring a one-step rule to a two-step rule, basis means value received.

D. Like-Kind Exchange

For policy reasons[74] not relevant here, Congress determined that realized gain will not be recognized on exchanges of certain non-cash properties, thereby encouraging certain barters. This favored treatment is accorded by I.R.C. § 1031(a)[75] to exchanges of properties like in kind[76] if, as to the taxpayer from whose perspective discussion proceeds, the property given was "held for productive use in a trade or business or for investment" and if the property received "is to be held either for productive use in a trade or business or for investment."[77]

The preceding situations included a purchase for cash, an exchange of non-cash properties, and an exchange of noncash properties of unequal value. In all these situations, the gain thought to be realized was recognized. The present example, a like-kind exchange, is therefore dramatically different from the preceding situations.

Suppose properties *X* and *Y* are like in kind and suppose the transaction otherwise qualifies for section 1031 treatment as to *A*, owner of property *X*. *A* exchanges property *X* with *B* for property *Y*. Suppose further that *A* previously paid $40 in cash for property *X* and consequently took $40 as his basis in the property. Properties *X* and *Y* are each worth $100 and *B*'s basis in property *Y* is $75.

As in the previous example, the gain realized on the exchange by *A* is $60. But the gain is not recognized, which is to say that, for purposes of exposure to the tax rates, the tax system will not take cognizance of the gain.

What basis will *A* now take in property *Y*? *A* must know his basis

74. *See generally*, Burke & Friel, *To Hold or Not to Hold:* Magneson, Bolker, *and Continuity of Investment Under I.R.C. Section 1031*, 20 U.S.F.L. REV. 177 (1986); Note, *California Tax Practitioners Beware: Even the Ninth Circuit's I.R.C. Section 1031 Loophole Has Limits*, 12 PEPPERDINE L. REV. 1129 (1985); Jensen, *The Uneasy Justification For Special Treatment of Like Kind Exchanges*, 4 AM. J. OF TAX POLICY 193 (1985); Guttenberg, *Continuity of Investment is Key to Using 1031 in Combination with a Corporate Transaction*, 60 J. TAX'N 280 (1984).

75. I.R.C. § 1031(a) (Supp. III 1985).

76. Treas. Reg. § 1031(a)(1) (1987); Friedman, *An Analysis of Nonrecognition Exchanges and Installment Rules Under the Recent Proposed Regulations*, 61 J. TAX'N 158 (1984); Guttenberg, *Continuity of Investment is Key to Using 1031 in Combination with a Corporate Transaction*, 60 J. TAX'N 280 (1984); Ronce, *Land and Improvements Are Definitely Not "Like Kind" (Are They?)*, 61 TAXES 382 (1983); Comment, *Loss Recognition Upon Sale and Leaseback: The Like Kind Exchange Controversy*, 28 LOY. L. REV. 1146 (1982).

77. I.R.C. § 1031(a)(1) (Supp. III 1985).

because, just as before, the property received might be sold. The values exchanged were equal so the particular problems raised by *Philadelphia Park*[78] are not of practical concern here. Either interpretation of the word "cost" will produce the same quantitative answer. Basis should be either $100 value given, or $100 value received. In light of section 1031, however, basis is neither the value given nor the value received. Instead, it is $40,[79] although *A* parted with property worth $100 and received property worth $100. This $40 is the amount of basis *A* had in property *X*. Since *A*'s tax position in *X* was one of built-in untaxed gain of $60, there should be built-in untaxed gain of $60 in property *Y* in *A*'s hands (since recognition of the gain is being deferred). In preserving *A*'s tax position expressed as basis ($40) through this unrecognized transaction, the tax system preserves, correctly, *A*'s tax position expressed as built-in untaxed gain ($60).

The immediately preceding example, involving a recognition exchange of noncash properties unequal in value, was sufficient to reject basis means cost means value given as a system-wide rule. Unlike that situation, here value received is *not* a linchpin for measuring gain precisely because this is not a recognition event. Value received, therefore, is *not* a touchstone for what new basis must be. New basis is old basis. So basis as value received must also be rejected as a system-wide rule.

Although the gain is not recognized in the exchange, the preservation of tax position will allow recognition of the gain later if *A* resells property *Y* for its value of $100.[80] Subtracting basis of $40, gain would be $60. The total gain *A* had in property *X* was $60. Gain recognized from exchange of property *X*, or $0, plus gain recognized from sale of property *Y*, or $60, totals the $60 of gain to be recognized in the two transactions. Aside from the important difference in timing of the income recognition, all is harmonious. Income, ultimately, will have been measured and taxed once.

The problem for a theory of basis presented by discussion of property *Y* in this example is that the preferred basis rule as determined by the preceding examples did not work here. The basis in the property received is not its value, nor does the statutory rule of basis as cost (in the sense of value given) work. *A*'s basis in property *Y* was *not* *A*'s cost of property *Y*, no matter how one quibbles over the meaning of the word "cost." The rule operating here is that the basis of property received is the *basis* of the property *given*. But application of this rule, well recognized by tax law, will not lead to the correct result in a *taxable* exchange of noncash properties, or in any other taxable exchange.

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78. Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1964).

79. I.R.C. § 1031(d) (1982).

80. *See Id.*

The rule operating in this example, that the basis of property received is the basis of the property given, may be seen, however, as one-half of the two-step rule that basis means prior basis plus gain recognized. It states the part of the rule that is relevant in a nonrecognition transaction. This rule was discussed previously and was not preferred before because it entailed two steps. This rule may have two steps, but its applicability to all situations thus far discussed makes it preferable to the other rules of less widespread applicability. It is a self-adjusting rule that will increase basis when gain is recognized but leave the increase $0 in quantity when gain is not recognized. It goes without saying that this rule is not a version of "basis means cost."

E. *Mixed Like-Kind Exchange*

The basis rule thus far found to be of universal application is contained within I.R.C. § 1031(d),[81] drafted in contemplation of the fact pattern in which a person who parts with property receives a mixture of otherwise qualifying like-kind property *and* nonqualifying property. In the interest of simplicity and to bring the mechanical statutory rule more fully into play, the nonqualifying property will be cash.

As seen, I.R.C. § 1031(a)[82] provided for nonrecognition of gain realized in a like-kind exchange. It contemplated a pure like-kind exchange. Here, I.R.C. § 1031(b)[83] provides that the realized gain will be recognized, but only "in an amount not in excess" of the value of property received beyond the like-kind property, or that property which is received to boot. This property, cash in this example, is in fact commonly called "boot."[84]

Suppose *A* and *B* exchange properties *X* and *Y*. *A*'s basis in property *X* is $40 and the value of property *X* is $100. *B*'s basis in property *Y* is $75, but the value of property *Y* is $85. *A* and *B* know the values of these properties, so they have agreed that *B* will pay to *A* the sum of $15 in cash, to boot.

As before, *A* enters the transaction with built-in untaxed gain of $60 and realizes all of this gain. *A*'s amount realized is the $85 value of property *Y* plus $15 cash, or $100, pursuant to the formula of section 1001(b). Subtracting *A*'s basis of $40 pursuant to the formula of I.R.C. § 1001(a) yields the realized gain of $60. Pursuant to I.R.C. § 1031(b), *A* will recognize this gain but only up to the value of the boot. Since the realized gain

81. *Id.*

82. I.R.C. § 1031(a) (Supp. III 1985).

83. I.R.C. § 1031(b) (1982).

84. *See, e.g.*, Turnbow v. Commissioner, 368 U.S. 337 (1961); Drayton v. United States, 801 F.2d 117 (3rd Cir. 1986), *cert. denied*, 107 S. Ct. 1972 (1987); Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980).

exceeds the boot of $15, that boot will act as a cap on the amount *A* must recognize.

Since *A* had built-in untaxed gain of $60 and recognizes only $15 of that gain, *A* must have built-in untaxed gain of $45 after the transaction. *A*'s property consists of property *Y* and $15 cash. As noted, the value of property *Y* is $85. If the basis of property *Y* is set below its value of $85 by the amount of required built-in untaxed gain of $45, its basis will be $40.

This *is* the basis of the property according to I.R.C. § 1031(d), although the terms of that subsection sound different. In basic part, the subsection provides that:

> the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized . . . .[85]

Under this language, the basis which *A* has in property *Y* will be the basis *A* had in property *X*, $40, reduced for $15 cash received to $25, increased by gain recognized of $15 back to $40, and reduced by $0 for $0 loss recognized. This sets basis at $40, the amount predicted by the known exigencies of the tax system. Aside from problems of timing, income will be taxed, but only once.

It will be recalled that the basic dichotomy between taxable and nontaxable transactions created a divide which could not be crossed by certain otherwise seemingly universally applicable basis rules. The rule which remained universally applicable was the two-step rule of basis as prior basis plus gain recognized. This rule was of interest for having solved mechanically the basis problem posed by the complications of mixing taxation and nontaxation in one transaction. The present four-step rule of I.R.C. § 1031(d) contains those two steps within it and is therefore also of universal applicability in the situations so far examined. Its steps are interesting individually for the insights they provide.

Mechanically, application of the rule is a simple enough matter, but the rule has two features which make its logic difficult to understand. First, it calls actively upon knowledge of the rule that the basis of cash is always equal to its face value.[86] Second, it is critical to understand that the rule is not directed toward determining *A*'s basis (in the sense of *A*'s *total* basis), but rather *A*'s basis *in the like-kind property received*, or property *Y*. The

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85. I.R.C. § 1031(d) (1982).

86. Basis of cash is its face value. Spector v. Commissioner, 71 T.C. 1017 (1979); *In re* J.S. Cullinan, 5 B.T.A. 996 (1927); California & Hawaiian Sugar Ref. Corp. v. United States, 311 F.2d 235 (Ct. Cl. 1962); Gillin v. United States, 423 F.2d 309 (Ct. Cl. 1970); Factor v. Commissioner, 281 F.2d 100 (9th Cir. 1960).

second problem is due partly to the fact that I.R.C. § 1031(d) never specifies the property whose basis is determined by the section 1031(d) four-step basis rule.

Step 1. The basis of the newly received property *Y is the same as the basis of the property just given.*[87] By itself, this is not new. This rule was seen in discussion of the pure like-kind exchange situation above. Unless *A* has used the basis of $40 somewhere else, *A* gets to keep the basis. This basis of $40 records *A*'s tax position. Since no change of tax position by recognition is involved in step 1, it follows that *A*'s tax position does not change. Basis after step 1 is $40.

Step 2. The basis of the newly received property *Y* is the same as the basis of the property just given, *reduced for cash received.*[88] This is the first example thus far presented in which the taxpayer from whose vantage the system is viewed receives cash.

This step of basis reduction for cash received requires special insight because both factors which make the four-step basis rule of I.R.C. § 1031(d) difficult to understand bear on this step. The basis decreases for cash received, $15; but the basis that decreases is just the basis in the newly received like-kind property. *A*'s *total* basis does *not* go down. Some of it simply moves. Since the $15 of cash must have basis of $15, it gets $15 of the basis that otherwise would stay in the newly received like-kind property. This shift is dictated by the rule that cash must have basis equal to its face value. This is a priority rule without which cash could not serve its ultimate clearinghouse function in the system.

Putting steps 1 and 2 together and viewing them in the order in which the steps appear in I.R.C. § 1031(d), then in step 1 the prior basis of $40 is placed in property *Y*, giving it a basis of $40. In step 2 the basis is reduced by $15 to $25 because the $15 is needed in the cash. Because the basis of cash must equal its face value and the basis must come from somewhere, $15 of basis detaches from property *Y* and attaches to the cash. As in step 1, total basis has not changed, although its location has changed. The total basis of $40 still records *A*'s tax position, and since no change of tax position by recognition is involved in step 2, it follows that *A*'s tax position as expressed in total basis does not change. The basis hasn't gone away; it has simply moved, and the same person still has it.

Step 3. The basis of the newly received property *Y* is the same as the basis of the property given, reduced for cash received, *increased for gain recognized.*[89] By itself, this step is not new. This rule, that basis increases

87. I.R.C. § 1031(d) (1982).

88. *Id.*

89. *Id.* For starters, the language of step 3 contains an important limitation. Basis is not

when gain is recognized, was seen in discussion of *Philadelphia Park* above.[90] Here, as there, the purpose is to give *A* protection from having the same income recognized twice. Since *A* previously had $60 built-in untaxed gain but now has recognized $15 of that gain, *A* should have only $45 built-in untaxed gain left. *A*'s basis after step 2 was $25. In step 3 it is raised by $15 back to $40. Since the value of property *Y* is $85, *A* has the proper $45 of built-in untaxed gain called for by the need to measure income and tax it, but only once. The $45 of realized gain which was not recognized on the exchange, and only that $45, remains available for recognition and taxation in a later transaction.[91] This is the first step in which gain recognition occurred. This is therefore the first step in which the tax position changes. Expressed as built-in unrecognized gain, the tax position decreased. Expressed as basis, the standard way of keeping track of the tax position, it went up.

Step 4. The basis of the newly received property *Y* is the same as the basis of the property given, reduced for cash received, increased for gain recognized, *reduced for loss recognized.*[92] This step is nothing more than step 3 with negative signs. Understanding that a loss is, mathematically, a negative gain, the rule may fairly be expressed as a three-step rule, from which step 4 is omitted.

If step 2 is seen as a mere change in the *location* of basis, not really an adjustment in the *taxpayer's basis*, then the operative rules which remain are simply steps 1 and 3. Of course step 1 was itself merely a change in the *location* of basis, not really an adjustment in the *taxpayer's basis.* So the only rule remaining that had operative significance for *change* in basis rather than change in location of basis is that basis changes for amount recognized, up for a gain and down for a loss.

But concern is with what new basis is, not only with the amount (including direction) of change in basis from the particular transaction. Determination of what basis is, therefore, seems to require reference to two steps; first prior basis, and second, amount of basis change. And this is true whether one addresses the *taxpayer's basis* or the basis the taxpayer has in particular property.

This simple rule, that basis equals prior basis plus gain recognized, fairly reflects its more detailed four-step expression. Furthermore, the rule works in all situations thus far discussed. It is the same rule that was universally applicable to example *D* and all of the preceding examples. Its vitality continues. Any rule that has universal application is surely to be pre-

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increased for gain, or even for gain realized. The gain must in addition be recognized.

90. *See supra* text accompanying notes 47-66.

91. *See* I.R.C. § 1031(d) (1982).

92. I.R.C. § 1031(d) (1982).

ferred, especially if it seems to explain adequately what basis is and how it got there. This seems true so far only for the I.R.C. § 1031(d) four-step rule including its two-step expression.

Step 2 was the step of greatest interest in the four-step rule of I.R.C. § 1031(d), in part because it was new but also due to a certain inherent complexity. Since a portion of the noncash property is given for the cash, the facts contemplated in step 2 bear a resemblance to a sale.[93] This will be the next situation discussed.

F. *Sale*

Whenever there is a purchase, there is a sale. A full discussion of the transaction involving a purchase, the first situation discussed above, therefore inherently requires discussion of a sale. The analysis contained herein is viewed, however, from the perspective of a single taxpayer, notwithstanding that the same analysis may be universally applicable to all taxpayers in the same situation. The logic herein of discussing sale separately from purchase, and doing so subsequently, is that it is useful for present purposes to continue looking at downstream transactions from the vantage of the same taxpayer. This is so that the purpose and functioning of basis through a series of transactions may be more easily grasped.

What will be said here about taxpayer *A* is applicable to taxpayer *B* in the first situation above. The present discussion is placed here, however, for while *A* was the purchaser above, *A* is the seller now. *A* is selling property *Y* acquired by exchange of property *X* which *A* originally purchased. The full cycle of the system may thus be seen.

Suppose *A* sells property *Y* at a new value of $120, representing an increase of $35 in value from its $85 value when *A* acquired it. *A*'s basis in property *Y* going into the sale, it will be recalled, is $40. The sale is to *C* for cash. *A*'s gain will be amount realized, or $120, less basis of $40, for gain of $80. That was the amount of built-in untaxed gain before the sale, and all of it is realized and recognized.

This time the property which *A* receives is cash. To perceive the applicability of the basis rules found to be of universal application thus far, it is necessary to focus on the fact that cash is a form of property. It is not like-kind property, to be sure, but it is property. If the prior rules are extended to cash on the grounds of applicable principles, whether a statute says to apply them or not, some interesting things happen. Proceeding under the carefully thorough four-step expression of the universally applicable two-step rule, *A*'s basis in this property will be the same as the basis of the

93. The resemblance is one of identity.

property given, property *Y*, or $40. This will then be reduced for cash received of $120 to negative $80 so that basis of $120 may go into the cash. Basis will then be increased for gain recognized of $80 back up to $0. *A*'s basis in the cash will thus be $0 plus $120, for a total of $120. Since the property received is the cash, one can think of the reason for basis of $120 being in the cash as changing in this step. Or, to avoid the here merely semantic step of saying the basis "moves" to where it already is, one can simply drop step 2.

Alternatively, one can be quite formalistic in application of I.R.C. § 1031(d) to a sale for cash. The results are instructive if for no other reason than demonstration of the adaptability of the rule. The only property *A* receives is still cash. Therefore one might refer to the like-kind property that *A* receives as being $0 in value or quantity. This approach will avoid the need to speak of basis "moving" to where the basis already is. Thus, *A*'s basis in the nonexistent like-kind property which *A* doesn't receive is the same as *A*'s basis in the property given, property *Y*, or $40. This basis amount, now truly free floating, is then reduced for cash received of $120 to negative $80, since the amount of $120 cash received *must* have basis of $120. Basis in the nonexistent like-kind property will then be increased $80 for gain recognized, back to $0, which happens to be where it started before it was given the transferred $40 of basis. Since the property does not exist, it is fortunate that its basis turns out to be $0. The property that was really received, the $120 cash, has the $120 basis it must have. But notice how readily the four-step basis rule adapted to the situation.

This should not be surprising. A mixed like-kind exchange is simply a pure like-kind exchange with boot. The reduction of the portion of like-kind property received to less than 100% does not destroy the applicability of the logic of the like-kind exchange to the like-kind property, *pro tanto*. Nor does the presence of like-kind property render the logic of normal barter exchanges or sales, as the case may be, inapplicable to the boot, again *pro tanto*. The mixed like-kind exchange starts the slide in percentage terms of like-kind property down from 100%. It is but one more step to say that a sale for cash is a like-kind exchange, in which the slide in percentage terms of like-kind property is simply reduced to the opposite extreme, of 0%. So viewed, the basis rule of section 1031(d) is of universal applicability. The self-adjusting parts of this structural mechanism are harmonious reflections of the self-adjusting parts of the structural mechanism of amount realized, discussed above. This second alternative sees the full promise of the functional use of the structural mechanisms involved.

Notice how both of these approaches satisfy the rule that the basis of cash will always be its face value.[94] *A* has $120 cash with a basis of $120.

94. *See supra* note 86.

Ultimately, both approaches even satisfy the rule that the basis of property will never be less than $0.[95]

Ignoring the complexities of the four-step rule, its two-step expression would simply indicate that the basis of the cash in *A*'s hands in this sale is prior basis of $40, plus gain recognized of $80, for total basis of $120. It is worth noticing that interpretation of basis as value given, or as value received, would also yield basis of $120.[96] In other words, it works here that basis means cost, although in saying so it is important to remember that discussion here concerns a sale, not a purchase. This suggests a different merger of concepts. As is obviously true and has already been stated, every purchase involves a sale. But in saying this, the transaction is being viewed from the other side, from the perspective of the other party. However, there is a different and more telling sense in which every purchase involves a sale. The perspective of a seller, it is suggested, can be adopted by a buyer without moving to the other side of the transaction. And the seller, in the conventional sense, can adopt the perspective of a purchaser (while remaining the seller). When *A* purchased those candlesticks in the first example, it is instructive to realize that in that very act, *A*, the same person, may be thought to have sold cash for candlesticks. And here, when *A* sells property *Y* for cash, *A* may be thought to have purchased cash for property *Y*.

As this example makes clear, a portion ($80) of the basis which *A* has in the cash ($120) is explained by the gain recognized on the transaction. If this were not so, *A* would get only $40 of basis in the $120 of cash. Basis of $40 in the cash should result, of course, only if the gain were not recog-

95. Roehner & Schlesinger, *More on: Can Cash have a Basis of Less than Cash?*, 28 TAXES 126 (1950); Schlesinger, *Caveat Reiterated: Planning Partnership Liquidations to Avoid Risk of Taxable Gain*, 27 TAXES 731 (1949); Roehner, *Can Cash have a Basis of Less than Cash?*, 27 TAXES 516 (1949); Schlesinger, *"Thin" Incorporations: Income Tax Advantages and Pitfalls*, 61 HARV. L. REV. 50 (1947). Although the steps in the four-step rule may fairly be thought to happen simultaneously, the manner of expressing the rule in the situation in which it was said to address the basis of nonexistent property allows the easy observation that a holding account was being used. If this analysis is applied to the preceding alternative for expressing it, where the basis of the cash property received was the focus of analysis, the moment of a drop in basis to negative $80 may also be thought, instead, to create a holding account.

In both cases, the holding account may be thought simply to mean that it will be necessary to explain an additional $80 of basis, the basis above $40 in the $120 cash. Fortunately, the explanation turns up immediately in the form of recognized gain, but the explanation is more harmonious with the rule that basis never drops below $0.

This same logic, of course, can be applied profitably to the mixed like-kind exchange example above. There, property like in kind was actually received. No negative basis was discussed because there was no need to do so. This was an accident of the facts. The initial basis *A* had in given property *X* easily could have been set below the amount of cash received. In this case the need to discuss negative basis, or the alternative holding account expression, would have arisen earlier.

96. This is an accident of the fact that the values exchanged are equal.

nized. In this case, treating cash like any other property, it would be necessary for *A* to recognize the $80 of built-in untaxed gain when next exchanging this property (cash) for other property. The very oddness of contemplating the treatment of cash like that of any other property indicates how ingrained the practical ramifications of the rule are that the basis of cash must always equal its face value, even though cash *is* property. Cash serves as *the* after-tax, clearinghouse mechanism of the income tax system. Almost by its very nature, cash is after-tax cash, acquired in recognized transactions. Thus, the rule regarding its basis is able to operate coherently, without creating the havoc which would attend the possibility that basis and face value of cash might be different.[97]

V. DISCUSSION

The two-step basis rule that basis in newly-acquired property will be the prior basis in property given plus gain recognized, of which the four-step rule of I.R.C. § 1031(d) should be considered but an elaboration, is the only rule among all those considered which is of system-wide applicability. This is a strength and this rule therefore deserves further analysis.

Cash was the property given only in the initial example — the purchase. There, the statutory rule that basis means cost seemed to work well, and the word "cost" in that rule had its real meaning — value given. This rule accurately determined basis in a cash purchase when, as above, it was thought that the values exchanged were equal. But the rule's predictive power did not depend on equality of values exchanged in that example. The basis of property received in a cash purchase would be the amount of cash given even if the acquired property had a value more or less than the amount of cash, for a purchase is not a recognition event.

Since face amount is the value of cash by definition, the value of the cash given will be the basis in the property received. Put differently, the value given or cost will always be the basis of the received property in a cash purchase. But this rule applied only one other time among the situations examined.

In a cash purchase, basis as cost applied whether values exchanged

97. In a sense, cash serves the same function in the tax system that it serves in the economy in general. It is the base of reference for all else. Even when speaking of aspects of candlesticks, for tax purposes one does not record the cost, basis, value, etc. of the candlesticks in terms of pea pods. One speaks in numbers of dollars, even though one is speaking of aspects of candlesticks, not aspects of dollars. When one does speak of dollars, one also speaks in terms of dollars. But the discussion is typically much simpler. This is because different aspects of cash are quantitatively the same almost by definition as legal tender. For purposes of the economy the fair market value of cash is equal to its face value, or face amount. So also, for purposes of tax law, the basis of cash is equal to its face value.

were equal or unequal, a cash purchase not being a recognition event. Switching to recognition events, exchanges of noncash properties were examined. Basis as cost worked only when the properties exchanged were equal in value. As soon as they were unequal, a situation treated as a separate example because the difference mattered, basis as cost worked only because the definition of cost was changed — which is to say that, using the word "cost" with its true meaning, basis as cost did not work. There, basis as prior basis plus gain recognized was one rule discussed and found applicable. It was tested in further examples and continued to apply. This was true when there was a switch back to a nonrecognition event, the pure like-kind exchange, the example that succeeded in eliminating all rules theretofore discussed except basis as prior basis plus gain recognized. This rule survived the transition back through a mixed like-kind exchange, part nonrecognition and part recognition, to a sale for cash, a full recognition event.

Basis as prior basis plus gain recognized had wide applicability, particularly across the divide between nonrecognition and recognition events, because of its inherent flexibility. Prior basis becomes part of new basis unless, of course, there is no prior basis. Recognized gain becomes part of new basis unless, of course, there is no recognized gain. But nowhere did there arise in any example discussed in this article, and nowhere does there arise in income measurement and taxation, any basis that cannot be explained either by prior basis or by gain recognized.

The Code starts discussion of basis with the postulate that basis means cost. This is the general rule. It works for a cash purchase, surely a common situation. But the basis of cash equals its face amount which equals its value. Basis and value given in a cash purchase are the same dollar quantity. This is why basis as cost meaning value given works in the case of a cash purchase. If a recognition event occurs and the values exchanged are equal, then cost meaning value given equals prior basis plus gain recognized. Here, too, basis as cost will work because the cost happens to equal the prior basis plus gain recognized. But it generally is true that the Code has an explicit exception to the rule that basis means cost in any situation in which the basis and value given are not the same, unless tax recognition of the difference allows basis as cost to happen to work. Examples are I.R.C. § 1031, which was discussed, and I.R.C. § 1033, which was not.

Put briefly, when basis and value given are the *same*, the Code says to look at value given, or cost; the Code thereby achieves the same dollar result that would be achieved if, as the Code does not, the Code were to say to look at prior basis. When prior basis plus recognized gain equals value given, the Code says to look at value given, or cost; the Code thereby achieves the same dollar result that would be achieved if, as the Code does not, the Code were to say to look at prior basis plus gain recognized.

Otherwise, in situations addressed by the Code, it draws an exception.

It says, in essence, to look to prior basis plus gain recognized, instead of looking to cost. When it doesn't matter which rule operates, the Code directs attention to cost. This allows the comfort that the Code seems to make sense in the transaction familiar to most people. But when it does matter, because the answer will be different, the Code looks to prior basis plus gain recognized. Whenever the result would be different under these two rules, tax law looks to the latter rule. It looks to basis as cost *only* when that rule achieves the same result as would be achieved under basis as prior basis plus gain recognized. This makes it fair to wonder whether tax law really means what it says in looking to cost in the accidental circumstance when cost equals prior basis plus gain recognized.

The Code's multiplication of rules without necessity does not make for conceptual coherence. Thinking that it is the second rule, not the cost rule, that is really being followed serves the aesthetic benefit of unifying the field of basis when income is to be measured and taxed. So viewed, basis as cost is not a rule that is ever operating. Rather, it is a mere mechanical device or convention to assign the correct dollar amount as basis in a very limited set of circumstances, such correct dollar amount being determined by the fact that it is equal to the prior basis plus the gain recognized. Put differently, basis as cost is but a linguistic device which serves as an introduction in the common situation, but it does not *explain* what is happening even there. It is but a mechanical device which does not contain within its words the reasoning, or justification, involved. It thereby begins discussion of the subject with a purely mechanical rule. The multiplicity of rules for other situations required by this starting point encourages a view of tax law as a set of static rules, rather than as a dynamic and fluid system.

Two factors may explain why the statutory language of basis as cost lingers. First, there is the transaction-specific dimension of the analysis involved. The gain from buying and selling *property X* really is the difference between the amount realized on sale and the cost of property *X*. Aside from indirect costs which will not be considered in the simplest of cases, the gain is accurately measured. The analysis does not look back through time past acquisition of property *X*, but there is no need to do so. Inquiry relates only to the gain from the specific transaction. *Why* that was the gain was not part of the question. And why *only* that gain should be the object of the tax is not a question that would arise when the inquiry is so narrow. Indeed, the reasons seemed obvious enough. Only reflection on other situations, where the basis on which gain was computed proved not to be cost, required analysis of the why of basis there, and consequently the why of basis in the case of the cash purchase in an effort to unify the field.

The fact that basis in cash equals face amount equals value allows the system-wide rule of basis as prior basis plus gain recognized to operate accurately and validly in the case of the cash purchase. Its flexibility allows reaction to the basis which pre-exists in the cash before the purchase, with the second step in the rule increasing that basis in the amount of gain recognized of $0 (or, put differently, with the second step not operating because it is not needed). This two-step rule itself does not really explain basis but only provides for its calculation. It has benefits, however. It allows for calculation using but one rule, and its content is suggestive of the proper direction for running the underlying meaning of basis to ground. The two-step rule at least looks in the right place for calculating basis in a cash purchase, whereas the cost rule reaches the correct result by accident.

Second, there is the history of the introductions of the words "basis" and "cost" into tax law. They came in by accident. Their introduction looked to the contrast from March 1, 1913, value as the base for calculation, and they had the transaction-specific situation in mind. The theoretical underpinnings of the steps in the calculation of gain were not at issue when the statutory framework for that calculation was created. It was not even realized that "basis" as a special concept in tax law had been introduced. It could not be expected, therefore, that the theoretical underpinning of the concept of basis, or, forgetting such special words, of *why* cost is subtracted in measuring gain, would be explicit in the statutory scheme.

An amount equal to prior basis was looked to in all examples given, even if the amount appeared under the guise of the amount of cash paid in the purchase example. Any time gain was recognized in any of the examples, basis was increased to reflect that gain. So in the second step, basis comes from gain recognized for the purpose of preventing its recognition a second time. In the first step, basis comes from prior basis for the purpose of preventing recognition as gain of revenue already being protected by basis. But this does not explain *why* that prior basis deserves to shelter revenue. The only *reason* in this so far is in the second step, recognition. That same reason, it turns out, can be found in the first step. What prior basis and amount recognized have in common is that they are the same thing. One must merely look back in time to see this.

This can easily be seen if one first takes a step forward in time and then starts heading back in time. Example *B* will serve the purpose. If candlesticks with a basis from a cash purchase for $40 are traded for 100 loaves of bread valued at $100 total, gain of $60 is realized and recognized. Basis of $100 is obtained in the loaves. If the loaves are sold for $110 worth of fish, that fish will have a basis of prior basis from the loaves of $100 plus gain recognized of $10 for total basis of $110. Where the basis in the second step came from, and why, is clear. The $10 of gain recognition justified the basis increase of $10.

Where the basis in the first step came from is equally clear. It came from the prior basis of $100. But why? Well, going back in time, the prior basis of $100 came from yet prior basis in the candlesticks of $40 plus recognized gain of $60. This gain was recognized in the immediately preceding transaction (in which the candlesticks were traded for the loaves). That explains by recognition an additional $60 of the $110 of basis in the fish.

Together with the $10 already explained, $70 is explained leaving $40 unexplained. That $40 came from the cash, which always has basis equal to face amount. But that hardly explains *why* it is justified in doing so. The reason that cash must have basis equal to face value and the function cash serves in the tax system reflect why cash is justified in having basis equal to face value. When the income tax system is allowed to operate, cash is, as was said earlier, after-tax cash almost by definition. The cash passed through a recognition event to reach *A*'s hands. If *A* had sold the candlesticks for $110 cash instead of trading them for fish, that which justified the top $10 of basis would be apparent. Looking to the prior transaction one would discover recognition again as the justification for an additional $60. One has only to look yet further back in time to find recognition justifying the remaining $40 of basis. It may be in the next preceding transaction, if for instance the $40 was acquired as wages for labor, or it may require looking back through an extended series of transactions. But recognition at one time or another will be found.

Thus, the two-step rule, prior basis plus gain recognized, may be seen as a one-step rule. Basis means amount recognized, its two-step breakdown merely having to do with the timing of recognition. It may be seen as a doctrine of basis justification by recognition alone. As a one-step rule, which explains all of basis in all situations discussed and throughout the system of income taxation when the true income tax system is allowed to operate, it represents a unified field theory of basis. This makes sense. The only reason that wealth should not be taxed in an income tax system is that it has already been taxed.

VI. Purview of Rule

A. Introduction

The position taken herein is that not only does recognition of gain justify basis, but *only* recognition of gain justifies basis. There are certain policy overrides to the tax system which have been grafted onto the Code.[98]

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98. *See generally*, Bradley & Oliver, *Investment Tax Credit: The Illusory Incentive*, 2 VA. TAX REV. 267 (1983); Balboni, *Investment Incentives for Business Taxpayers: Analysis and Planning Techniques*, 13 CUM. L. REV. 329 (1982-83); Parker, *New Tax Rules for Depreciable Assets: Assessing the Impact*, 34 TAX EXEC. 181 (1982); Zimmerman, *Federal Tax Policy, IDBs and the Market for State and Local Bonds*, 37 NAT'L TAX J. 411 (1984); Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U.L. REV. 1030 (1983); Wiedenbeck, *Charitable Contributions: A Policy Perspective*, 50 MO. L. REV. 85

Commonly referred to together as the tax expenditure system, these policy overrides are sometimes meant to be included in the phrase "income tax system." This broad meaning of the phrase would call anything part of the income tax system, as long as it was put in the right place in title 26 of the United States Code. So construed, a provision that prevents the accurate measuring of income for Code purposes and thereby prevents the recognition of economic income will also be called an income tax provision. This usage of the phrase "income tax system" is so broad as to destroy the meaning of the words in the phrase.

There are certain basis rules which can be found in the Internal Revenue Code that might seem contrary to the position taken in this article, that only recognition of gain explains basis in the income tax system. Prominent candidates would be the basis rules for property transfers made by inter vivos gift and at death.

B. Gift

The Code rules regarding the income tax treatment of the parties to a gift work an important distortion on the jurisprudence of income taxation law. The basic basis rule for gifts is provided by I.R.C. § 1015.[99] The rule is that the donee takes the basis that the donor had. When considered in connection with treatment of the donee's income, that the value of the gifted property is specifically excluded from gross income for tax purposes by I.R.C. § 102(a),[100] the result is odd. Situations involving no basis change and no recognition were seen. Situations involving basis change and recognition were seen. But here, the donee's basis goes from $0 up to whatever basis the donor had, without the donee recognizing any income.

The Code does not specifically provide that the donor recognize no income on the occasion of making a gift. That this is so is not in doubt, however. If continuing to hold appreciating property does not result in recognition of income, parting with that property could only with difficulty result in income to the donor.

While a unilateral exchange may seem not to be an exchange at all, pretending that it is an exchange might be required for recognition of gain on the transaction under the Code's present structure. Viewing it as an exchange, I.R.C. § 1001(a)[101] would measure the gain as the excess of the amount realized over basis. The very reason why it seems not to be an exchange also means that the measure of the gain, were it an exchange, would

(1985).

99. I.R.C. § 1015(b) (1982).

100. I.R.C. § 102(a) (1982).

101. I.R.C. § 1001(a) (1982).

be $0 for the donor.

The donor of a gift by definition realizes nothing, which therefore cannot exceed basis. Saying that it is not an exchange requires the inclusion in gross income, if there is to be recognition, to be on some other basis. All that is left is inclusion of the mere appreciation in value, which is never included.[102] Indeed, if it were to be included, it would have been included earlier, although no logic would prevent a rule that transfer by gift be an occasion for recognizing built-up appreciation in value. The irony here is that exclusion from gross income of mere appreciation in value is justified partly on the theory that the income will be included later on disposition when the exact quantity of income can be determined more readily due to knowledge of the disposition price. In the case of a gift, the guidance of a selling price is not available for value determination of amount realized even though, notwithstanding failure of income recognition, the property must be valued for gift tax purposes.[103]

As a result, the donor's income of mere appreciation in value forever escapes taxation, despite the donor's absolute command and direction of the full value of the property. It also means that the value of the gift, fully income to the donee at the time of the gift, is not then recognized as such.[104] To the extent this income of the donee equals the donor's basis, it will forever escape taxation to the donee precisely because the donee takes the donor's basis.[105] Any excess of this value above the transferred basis, however, may be taxed to the donee should the donee later dispose of the property for value received above basis. This excess, for the time being, is preserved for future taxation in the form of built-in untaxed gain of the donee. The point is that the donee obtained the donor's basis without ever recognizing gain.

C. Bequest

The recognition-free basis obtained by the recipient of property that passes at death is even larger.[106] Regardless of the decedent's basis at death, the recipient gets a basis in the property under I.R.C. § 1014[107] equal to the full value of the property. The amount realized becomes the recipient's basis without gain recognized or basis given, without even cost paid. This means that even the built-in untaxed gain in the property in the decedent's hands, never recognized as income by the decedent, is not taxed

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102. M.E. Blatt Co. v. United States, 305 U.S. 267, 269 (1938).
103. I.R.C. § 2512 (1982).
104. *See supra* note 100 and accompanying text.
105. I.R.C. § 1015 (1982 & Supp. III 1985).
106. I.R.C. § 1014 (1982).
107. *Id.*

to the recipient. The recipient takes recognition-free basis to the extent of the decedent's basis and also takes basis, similarly untainted by recognition, to the extent of the decedent's built-in untaxed gain.[108] These two components add up to the value of the property, although the code's methodology is direct. The value is the basis without a look at the components that make it up. Again the recipient of property receives basis without recognizing gain.

D. Analysis

It would be easy to make exceptions for situations in which the Code provides basis without recognition, but it is unnecessary. For starters, it is tempting to see a notion that the Code is treating the family rather than the individual as the relevant taxpaying unit when the basis transfer operates with gifts. Nonrecognition of gifts is a step, but only a step, beyond the implicit Code position in allowing joint filing that the two really have become one. The community property approach to marital property law regimes that the community is singular, rather than the explosively atomistic view of the family that the people are plural, is reflected in joint filing. Thus, the analysis of basis transfer from a gift arguably recognizes the reality that most gifts occur in the family context, although the income tax effects of a gift described above curiously are not limited to that context.

This explanation of the basis transfer in the case of gifts in its essence is a view that since the family property is still in the family, no relevant transfer has occurred. There is therefore no occasion for taxing inquiries. As a result, tax position, expressed in basis, remains unchanged. The basis is still in the family and attached to the property. It is still the same in quantity; that the property is owned by a different person, and that the basis inures to the benefit of a different person, is but a detail.

However appealing this tax entity view of the family may be in the case of inter vivos gifts, it cannot explain the basis *increase* that occurs when property stays behind because one cannot take it with one.

The reason that recognition-free basis in these situations is not an exception to the general rule is that it does not otherwise contradict the general rule. Rather, any objection based on them misperceives the general rule. The general rule is one of *income taxation*, and it applies when *income* is to be measured and taxed. It is a coherent theoretical understanding of what is really happening in a way that makes sense of the mechanical rules when they are used for *income tax* purposes. The basis rules applicable to gifts and bequests do not do this, and no one pretends that

108. It could be larger if an election were made under I.R.C. § 2032 (1982 & Supp. III 1985).

they do. Indeed, the very purpose of the free basis rules is to *prevent* accurate measurement of income for tax purposes, and thereby to prevent it from being taxed. These rules are not part of any true income tax system. They are foreign to it.

The rule described herein, which is claimed to have *no* exceptions, has to do only with situations where income is sought to be measured and taxed. Its main contributions are first, its challenge to the notion that basis means cost when one *does* want to recognize income and one's problem is in ascertaining the amount of the income, and second, its explanation of what basis does mean. When, instead, one is simply setting basis arbitrarily, in order to give special tax treatment to persons one feels should be privileged, there is no point in seeking or expecting to find a conceptually coherent theoretical explanation of basis since the accurate measurement of income is frankly sought to be avoided, not accomplished.

VII. Conclusion

This article started with the common notion that basis means cost. It described the structural Code context in which basis operates and pursued the history of how the feature of basis became part of the statutory framework. It showed that basis was intended to be used as a plain word and that this interpretation is precisely how the word in fact, if unconsciously, is used today.

The article then explored a series of six types of transactions in which tax law seeks to measure income and tax it, at least sometime if not necessarily immediately. It examined the utility of the interpretation of basis as cost. The cost meaning was found to work satisfactorily in the most common transaction, the cash purchase. It only worked in a minority of the types of transactions, however. If basis as cost were accepted as an explanation of basis in those situations where it worked, then different basis rules for different types of transactions would be necessary. The result of such a view, where the rules of basis would multiply further if additional types of transactions were introduced from other areas of tax law, could not be described as elegant in its simplicity.

That basis changes for recognition of gain was shown to be the only reason justifying basis when income is to be accurately measured and taxed. This demonstrates that cost never *explains* basis even when basis as cost yields the correct dollar amount for basis.

Prior recognition was offered as a system-wide rule, or unified field theory, of what basis really means in income measurement and taxation. And that theory was seen to make policy sense for an income tax system.

Two additional examples, whose actual statutory basis would differ in result from basis predicted by the recognition theory, were analyzed to reveal why they are not exceptions to the rule of basis as recognition in income measurement and taxation. It is because accurate income measurement is not their goal. When accurate income measurement and taxation are the goals, basis as amount recognized both calculates and explains the proper level of basis.