

Amount Realized and Cost Basis in a Property Transaction With Hard-to-Value Property

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In Private Letter Ruling 202352011 (December 30, 2023), the taxpayer asked the IRS to determine the amount that it will realize in a property transaction. The taxpayer will receive the property in an arm's length exchange with its counterparty, but the taxpayer will not be able to reasonably ascertain the value of the property received. The taxpayer will use the IRS value to calculate its amount realized on the exchange.[1]

The Proposed Transaction

The taxpayer appears to be a service provider and its counterparty is the recipient of the services. The taxpayer will provide future services for an arm's length fee. The taxpayer will guarantee that its arm's length fee for the services will yield a cost savings for the service recipient of a specified amount over the term of the service agreement in comparison to the fees that the service recipient incurs in its current service agreements. Also, the service recipient apparently will join the service provider's board and have certain control rights. In total, the taxpayer will provide future services, a guarantee, and provide a place on its board for the service recipient.

Tax Treatment

For tax purposes, it appears that the taxpayer's furnishing of the guarantee to the service recipient is the transfer of a property right to the service recipient.[2] The ruling further provides that the exchange in the proposed transaction is a disposition of property for each party,[3] which leads to the question what will be the value of the property received by the taxpayer – the amount realized – for furnishing the guarantee.

Analysis

To determine the taxpayer's amount realized (the value of the property received by the taxpayer), the IRS analogized the Proposed Transaction to the transaction in *United States v. Davis*,[4] which determined the tax treatment of a property settlement incident to divorce. The husband in *Davis* transferred appreciated stock to his wife who, in exchange, surrendered her inchoate marital rights in the husband's property. The Supreme Court held that the husband made a taxable disposition of his stock and that while the value of the surrender of the wife's inchoate marital rights were not readily ascertainable, in an arm's-length exchange the Court could assume that the value of the property given up by the husband equaled the value of the inchoate marital rights that the wife surrendered to him. The husband therefore realized the fair market value of the stock he had transferred to the wife, and his gain on the transaction was equal to the stock appreciation.[5]

Like the husband in *Davis*, the taxpayer in Private Letter Ruling 202352011 could not directly value the property that it will receive in the exchange, and so will not be able to determine its amount realized. The IRS found, however, that it could determine the value of the property that the taxpayer will give to the service recipient. That value, the IRS ruled, is the present value, if any, of the guarantee given to the service recipient. The taxpayer consequently will have gain on the disposition equal to the difference between its amount realized – the present value, if any, of the guarantee – and its

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basis, if any, in the property that the taxpayer will give up to the service recipient.

Corollary

Although not discussed in the ruling, a corollary to the “amount realized rule” in *Davis*, is the basis rule: the basis of the property received in an exchange is ordinarily determined by reference to the fair market value of the property received. The basis rule is counter-intuitive because the basis in property generally is its “cost,” which one would think is not the value of the property received but rather the value of the property given up. Nonetheless, for tax purposes, basis is the value of the property received in an arm’s length exchange,[6] which apparently will be the basis that the taxpayer will have in its contract with the service recipient.

Additional Support

The amount realized and basis rules are also discussed in the recently proposed regulations dealing with transactions in digital:

“Ordinarily, the value of property in exchange for other property received should be equal in value. Under Federal income tax law principles, in an exchange of property, both the amount realized on the property transferred and the basis of the property received in an exchange ordinarily are determined by reference to the fair market value of the property received. See *United States v. Davis*, 370 U.S. 65 (1962); *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954); Rev. Rul. 55-757, 1955-2 C.B. 557. This rule ensures that the sum of any gain or loss realized by the taxpayer in an exchange transaction in which property is received plus the gain or loss realized by the taxpayer in a subsequent transaction in which the property received in the first transaction is later sold will be equivalent to the customer’s economic gain on the combined transactions. Accordingly, proposed §1.1012-1(h)(1) provides that the basis of digital assets acquired in an exchange is generally equal to the cost of the digital assets received at the date and time of the exchange.”[7]

In conclusion, the IRS has consistently reinforced the rules that the amount realized in an exchange of property may be the value of the property given up rather than the value of the property received (*Davis*), and the basis of property received in an exchange may be the value of the property received rather than the value of the property given up (*Philadelphia Park Amusement*). The rules are both necessary and sometimes counter intuitive.

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[1] The IRS heavily redacted the ruling, but it is reasonably clear that the taxpayer will exchange property with its counterparty for other property, that the disposition is an exchange, and that the taxpayer will not be able to reasonably ascertain the value of the property that it will receive in the exchange.

[2] See IRC §1.263(a)(d)(6)(i)(B) (“(6). Certain contract rights—(i) In general. Except as otherwise provided in this paragraph (d)(6), a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party ... (B) An agreement providing the taxpayer the right to provide or to receive services (or the right to be compensated for services regardless of whether the taxpayer provides such services).”

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[3] IRC §1001(a) (“The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.”)

[4] 370 U.S. 65 (1962).

[5] The tax treatment of a property settlement in a divorce proceeding now is treated as a gift made by the transferor-spouse to the transferee-spouse, IRC §1041(b), but the tax principle expressed in *Davis*, that in an arm’s length property exchange, the parties are presumed to exchange equal value, survives intact.

[6] *Philadelphia Park Amusement Co. v. United States*, 126 F.Supp. 184 (Ct. Cl. 1954).

[7] Notice of Proposed Rulemaking, Fed. Reg. Vol. 88, No. 166, p. 59576 (August 29, 2023).