TAXPAYER EXHIBIT
B1a-c
December 14, 2010
Kingston Technology Corp. etal
480846, 480891, 480894

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal	)	
of	)	**Appeal Case ID Numbers:**
John and Mary Tu,	)	**480894**
David and Diana Sun, and	)	**480891, and**
Kingston Technology Corporation	)	**480846**

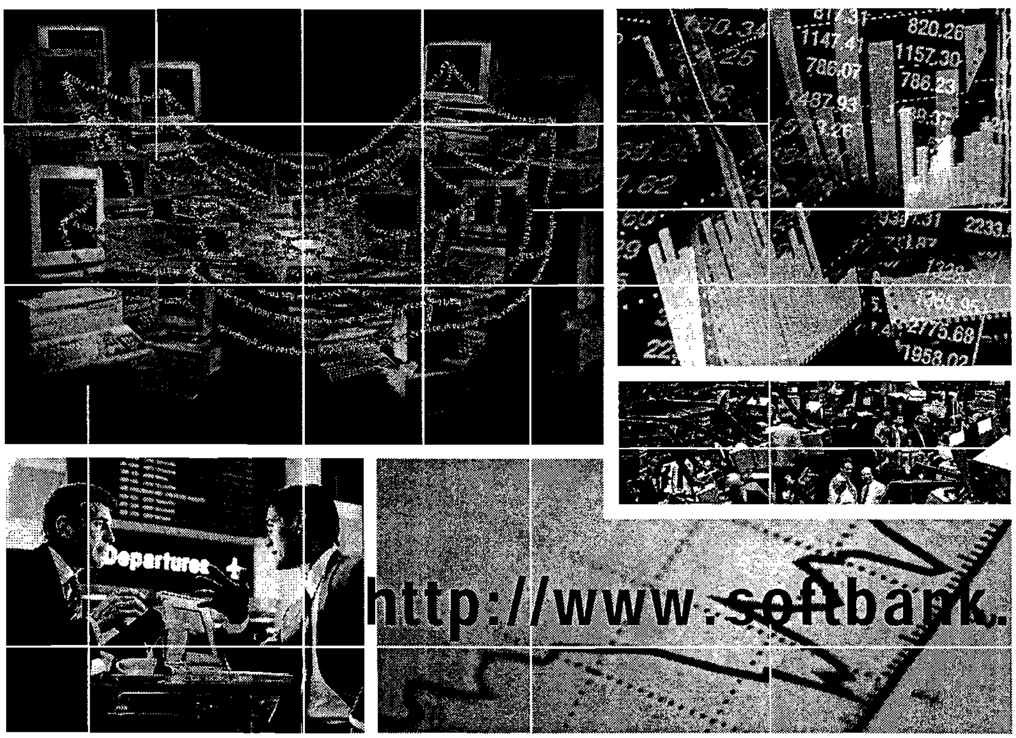
APPELLANTS' EXHIBITS

1. **EXHIBIT A:** **SOFTBANK CORP. - ANNAUL REPORT 1998**
2. **EXHIBIT B:** **THE REPURCHASE AGREEMENT - 7/14/1999**
3. **EXHIBIT C:** **SOFTBANK CORP. - ANNUAL REPORT 2000**
4. **EXHIBIT D:** **SUPPORTING CASES**
5. **EXHIBIT E:** **FAIR MARKET VALUE OF THE CONTINGENT NOTE AS OF 7/14/1999**

SOFTBANK CORP.

ANNUAL REPORT 1998

YEAR ENDED MARCH 31,1998



http://www.softbank.co.jp

PROFILE

Having secured leading positions in the areas of software & network products, media, technology events, technology services, and the Internet, SOFTBANK is a preeminent global provider of branded information services and infrastructure in the digital information service industry. Renowned worldwide for its aggressive policy of acquisitions, mergers, joint ventures, and business tie-ups, SOFTBANK constantly seeks new business opportunities in emerging areas of the digital information service industry, which will further unlock synergy among the SOFTBANK Group companies and create long-term corporate value.

CONTENTS

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

SOFTBANK CORP. AND CONSOLIDATED SUBSIDIARIES

1. ORGANIZATION AND NATURE OF BUSINESS:

SOFTBANK CORP. (the "Company") was incorporated in September 1981. The Company is a provider of information infrastructure and distribution services to the computer industry. The Company is principally engaged in the wholesale distribution of computer software and other computer-related products in Japan. The Company is also engaged, directly and through its subsidiaries, in the business of publishing computer-related magazines and books, management of computer industry trade shows and the design and manufacture of memory, networking and storage products for personal computers, workstations and printers. The Company and its subsidiaries have been operating principally in Japan and the United States, and are expanding in the United States and internationally through acquisitions.

The Company has a significant shareholder, MAC Inc., who at March 31, 1998 directly owned 44.43% of the shares of common stock of the Company. MAC Inc. is a company privately owned by Masayoshi Son, the president of the Company. Significant transactions of the Company with MAC Inc. are described in Note 17 of the Notes to the Consolidated Financial Statements.

2. BASIS OF PRESENTING THE CONSOLIDATED FINANCIAL STATEMENTS:

(1) Accounting Principles -

The accompanying consolidated financial statements of SOFTBANK CORP. and its subsidiaries were prepared from the accounting records maintained in accordance with the provisions set forth in the Commercial Code of Japan and the Securities and Exchange regulations of Japan and in conformity with generally accepted accounting principles prevailing in Japan.

The accounts of consolidated subsidiaries as listed in Note 3(1) of the Notes to the Consolidated Financial Statements are based on their financial statements prepared in conformity with generally accepted accounting principles and practices prevailing in the respective countries in which the subsidiaries have been incorporated. In general, no adjustments to the accounts of overseas consolidated subsidiaries have been reflected in the accompanying consolidated financial statements to present them in compliance with Japanese accounting principles and practices followed by the Company.

The accompanying consolidated financial statements have been prepared from the consolidated financial statements filed with the Ministry of Finance of Japan as required by the Securities and Exchange Law in Japan and in accordance with accounting principles and practices generally accepted in Japan.

Relevant notes have been added and certain reclassifications have been made to the consolidated financial statements filed in Japan so as to present them in a form which is more familiar to readers outside Japan.

(2) Acquisition of Kingston Technology Company -

On September 4, 1996, the Company, through its wholly owned subsidiaries SOFTBANK Holdings Inc. ("SBH") and SOFTBANK Kingston Inc., acquired an 80% interest in Kingston Technology Company ("KTC"), a partnership, for an aggregate purchase price of $1,508,000 thousand, consisting of $875,000 thousand in cash, a promissory note for $633,000 thousand, plus transaction costs. The excess of the purchase price over the fair value of the assets acquired and liabilities assumed was $1,592,125 thousand and is included in intangible assets. The remaining 20% interest is owned by Kingston Technology LLC ("KT LLC").

On October 23, 1997, the Company and KT LLC agreed to amend the terms of the acquisition agreement and exchange the remaining principal and accrued interest on the promissory note, totaling approximately $389,000 thousand, for a contingent note of $450,000 thousand. In conjunction with the replacement of the promissory note with the contingent obligation, the Company adjusted the purchase price of KTC by reducing intangible assets recorded in connection with the KTC acquistion. The contingent note, if paid, will result in an adjustment to intangible assets when paid.

The contingent note is due and payable upon either (a) KTC achieving a cumulative annual average earnings before interest and taxes, commencing January 1, 1997, of $300,000 thousand or (b) the closing of an initial public offering or sale of KTC at a valuation of at least $1,800,000 thousand (together, the "Trigger Events"). The contingent obligation is payable within one year, and bears interest at 7% per annum, from the date of occurrence of one of the Trigger Events. The obligation of the Company under the $450,000 thousand contingent note will terminate should one of the Trigger Events not occur by December 31, 2004.

(3) Purchase of MAC Assets and Other Affiliated Companies -

Concurrent with the Company's acquisition of Ziff-Davis Publishing Company (currently ZD Inc., "ZD") in 1996, MAC Inc., directly or through wholly owned affiliates, acquired certain assets and assumed certain liabilities of ZD (the "MAC Assets") for an aggregate purchase price of approximately $300,000 thousand. The Company and its subsidiaries maintained the right to repurchase any or all of the MAC Assets at any time up to five years following its acquisition of ZD. On October 31, 1997, the Company exercised its right to purchase certain of the MAC Assets from MAC Inc. for $100,000 thousand subject to certain price adjustments.

On January 1, 1997, the Company, through SBH, acquired certain limited partnership interests of SOFTBANK Forums Co., L.P. from Son Kosan Inc., the parent company of MAC Inc., for $10,000 thousand. During the year ended March 31, 1998, SBH also acquired certain other subsidiaries in transactions with Son Kosan Inc. and the Company at net cost of approximately $1,600 thousand.

As required under generally accepted accounting principles in the United States, the acquisitions described above have been accounted for in a manner similar to a pooling of interests as all entities involved are under common control. The financial statements include the result of operations and financial position of the entities acquired for the current period presented. Accordingly, the cumulative effect of the pooling of interests transactions is included in the accompanying consolidated statements of shareholders' equity.

PURCHASE AGREEMENT

PURCHASE AGREEMENT, dated as of July 14, 1999, between Kingston Technology Corporation, a California corporation ("Kingston"), and SOFTBANK Kingston Inc., a Delaware corporation ("SOFTBANK").

WHEREAS, SOFTBANK owns an 80% partnership interest (the "SOFTBANK Interest") in Kingston Technology Company, a Delaware partnership (the "Company"), formed pursuant to the Partnership Agreement, dated as of September 4, 1996, as amended as of October 1, 1997 (the "Kingston Partnership Agreement"), which interest was purchased from Kingston pursuant to the Purchase Agreement, dated as of August 15, 1996;

WHEREAS, Kingston proposes to repurchase and SOFTBANK is willing to sell SOFTBANK's interest in the Company (the "SOFTBANK Interest") on the terms and conditions set forth in this Agreement;

WHEREAS, SOFTBANK owns a 0.8% partnership interest (the "Apollo Interest") in Apollo Memory Systems Company, a Delaware partnership ("Apollo"), formed pursuant to the Partnership Agreement, dated as of September 5, 1996, among SOFTBANK, Kingston Technology LLC, a California limited liability company, and the Company (the "Apollo Partnership Agreement") (the Kingston Partnership Agreement and the Apollo Partnership Agreement are referred to collectively as the "Partnership Agreements"); and

WHEREAS, Kingston proposes to purchase and SOFTBANK is willing to sell the Apollo Interest on the terms and conditions set forth in this Agreement.

NOW, THEREFORE, in consideration of the premises and the mutual covenants herein set forth, the parties hereby agree as follows:

ARTICLE I

PURCHASE AND SALE

1.1 Purchase of Partnership Interest and Apollo Interest. On the terms and subject to the conditions contained herein, at the Closing (as hereinafter defined)

SOFTBANK will sell to Kingston, and Kingston will purchase from SOFTBANK, the SOFTBANK Interest and the Apollo Interest against payment of the total purchase price of $450 million, consisting of $250 million in cash and a promissory note for $200 million (the "Note") substantially in the form set forth in Annex A hereto.

1.2 Closing. Payment of the purchase price under Section 1.1 will be made by (i) wire transfer of the cash amount in immediately available funds to a bank account designated by SOFTBANK, and (ii) delivery of the Note to SOFTBANK at a closing (the "Closing") at 9:00 a.m., Los Angeles time, on July 30, 1999 or on such later date on which the conditions under Article V hereof are fulfilled or waived, at the offices of Sullivan & Cromwell, 1888 Century Park East, Los Angeles, California, or at such other time and place as the parties may agree. Any transaction charges relating to such wire transfer shall be borne by Kingston. The time and date of the Closing are herein referred to as the "Closing Date."

ARTICLE II

SOFTBANK REPRESENTATIONS AND WARRANTIES

SOFTBANK represents and warrants to Kingston as follows:

2.1 Organization. SOFTBANK is a corporation duly organized, validly existing and in good standing under the laws of the State of Delaware with full power and authority to consummate the transactions contemplated by this Agreement.

2.2 Authority. This Agreement has been duly authorized, executed and delivered by SOFTBANK, and constitutes a valid and legally binding agreement enforceable against SOFTBANK in accordance with its terms, except as limited by bankruptcy, insolvency or other similar laws relating to creditors' rights generally and subject to general equity principles.

2.3 SOFTBANK Interest and Apollo Interest. SOFTBANK owns the SOFTBANK Interest and the Apollo Interest free and clear of any and all equities, liens or claims and, upon payment of the purchase price as contemplated hereunder, Kingston will acquire the SOFTBANK Interest and

ARTICLE VI

TERMINATION

6.1 Termination. This Agreement may be terminated at any time prior to Closing as follows:

(a) by mutual consent of the parties hereto;

(b) by either Kingston or SOFTBANK if the other party shall breach in any material respect any of its respective representations, warranties or agreements contained in this Agreement; and

(c) by either Kingston or SOFTBANK if the transactions contemplated by this Agreement shall not have been consummated on or before December 31, 1999 (or such later date as may be agreed upon in writing by the parties hereto).

6.2 Effect of Termination. If this Agreement is terminated pursuant to Section 6.1, all rights and obligations (other than the rights and obligations provided by Sections 8.2 and 8.7) of each of the parties hereunder shall terminate, and no party shall have any liability to the other parties with respect thereto, except that any party which has breached this Agreement prior to such termination shall be liable to the other parties for their expenses incurred in connection with the transactions contemplated hereby.

ARTICLE VII

ENTIRE AGREEMENT

This Agreement, together with the Note and the Annexes hereto, constitutes the entire and only agreement between the parties and their affiliates relating to the matters covered hereby and thereby, and supersedes any and all prior arrangements, representations, provisions, understandings and conditions in connection with such matters, including, without limitation, (a) the Partnership Agreements, which shall be terminated at the Closing (except as provided below in this Article VII), (b) the Promissory Note and related Guarantee, dated as of October 1, 1997, by SOFTBANK in favor of Kingston Technology Corporation, which will be canceled and returned to SOFTBANK at the Closing,

(c) the Purchase Agreement, dated as of August 15, 1996, and the Supplement to Purchase Agreement, dated as of August 30, 1996, each among Kingston, SOFTBANK Holdings Inc. and SOFTBANK and (d) the Stock Purchase Agreement, dated as of August 15, 1996, between KTC-Sun Corporation and KTC-Tu Corporation, on the one hand, and SOFTBANK Corp., on the other, and the Stock Repurchase Agreement, dated as of September 4, 1996, between MAC Inc. and KTC-Sun Corporation and KTC-Tu Corporation; provided, however, that SOFTBANK's obligations to indemnify Kingston and its direct and indirect owners for taxes and other charges pursuant to Section 5.3(e) of the Partnership Agreements and Section 3 of the Amendment, dated as of October 1, 1997, to the Partnership Agreement shall survive the termination of the Partnership Agreement and the consummation of the transactions contemplated hereby and shall not be modified or affected in any way by any amendment to the Partnership Agreement effected concurrently with or following the Closing. Subject to the proviso to the immediately preceding sentence, effective at the Closing, Kingston and its affiliates, on the one hand, and SOFTBANK and its affiliates, on the other, shall be released from all liabilities under the Partnership Agreements, as amended, such Promissory Note and related Guarantee, Purchase Agreement, Supplement to Purchase Agreement, Stock Purchase Agreement and such Stock Repurchase Agreement.

SOFTBANK ANNUAL REPORT 2000

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Ex C

Directors and Corporate Auditors

As of June 22, 2000

Standing from left: Hidekazu Kubokawa, Saburo Kobayashi, Yasuharu Nagashima, Mitsuo Sano, Den Fujita, Yoshihiko Miyauchi, Kenichi Ohmae, Jun Murai
Seated from left: Ronald Fisher, Ken Miyauchi, Masayoshi Son, Yoshitaka Kitao, Kazuhiko Kasai

Directors

MASAYOSHI SON
President & Chief Executive Officer,
SOFTBANK CORP.

YOSHITAKA KITAO
President & Chief Executive Officer,
SOFTBANK FINANCE
CORPORATION

KEN MIYAUCHI
President & Chief Executive Officer,
SOFTBANK E-COMMERCE CORP.

KAZUHIKO KASAI

RONALD FISHER
Vice Chairman of the Board,
SOFTBANK Holdings Inc.

DEN FUJITA
President,
McDonald's Company (Japan), Ltd.

YOSHIHIKO MIYAUCHI
Chairman and Chief Executive Officer,
ORIX Corporation

KENICHI OHMAE
President,
OHMAE & ASSOCIATES, Inc.

JUN MURAI, Ph. D.
Professor,
Faculty of Environmental Information,
Graduate School of Media and Governance,
KEIO University

Corporate Auditors

MITSUO SANO
Full-Time Corporate Auditor,
SOFTBANK CORP.

YASUHARU NAGASHIMA
Attorney

SABURO KOBAYASHI
Full-Time Corporate Auditor,
HEIWA Corporation

HIDEKAZU KUBOKAWA
Certified Public Accountant,
Certified Tax Accountant

Note: Corporate auditors Yasuharu Nagashima, Saburo Kobayashi, and Hidekazu Kubokawa are outside corporate auditors appointed under Article 18, Section 1 of the Commercial Code of Japan.

(6) Sale of Kingston Technology Company

In July 1999, SOFTBANK Kingston Inc. (a subsidiary of SBH) sold its 80% interest in Kingston Technology Company for $450 million. The loss on sale, including operating results for the period ended July 31, 1999, of approximately $676 million (¥76,936 million) has been reported as a loss on discontinued operations in the accompanying consolidated statements of income.

(7) Sale of Trend Micro Investment

In March 2000, Softbank America Inc. (a subsidiary of SBH) sold its remaining interest in Trend Micro Incorporated. The Company recorded a pre-tax gain of ¥61,336 million in connection with the sale of its Trend Micro investment.

(8) Initial Public Offering of UTStarcom

In March 2000, the Company's majority owned subsidiary, UTStarcom, completed its initial public offering (IPO). UTStarcom sold 11.5 million shares of common stock, for gross proceeds of $192 million. As a result of the IPO, the Company's investment in UTStarcom was diluted from 56% to 49%, but as at the end of this fiscal year, UTStarcom is reported as a consolidated subsidiary because the Company has significant influence over the company.

The Company recognized a dilution gain on its investment in UTStarcom of $77 million (¥8,209 million) in March 2000.

(9) Discontinued Operations

The Company discontinued operations of SOFTBANK Content Services Inc. and SOFTBANK Services Group in December and September 1998, respectively, and the above discontinuance resulted in losses on sale of stock (¥1,676 million) and losses from discontinued operations of (¥1,540 million) in fiscal year 1998.

6. Inventories:

Inventories as of March 31, 2000 and 1999 consisted of the following:

	Millions of yen		Thousands of U.S. dollars (Note 4)
	2000	1999	**2000**
Merchandise	**¥ 7,996**	¥10,525	**$ 75,327**
Finished goods	**2,615**	4,949	**24,635**
Work in process	**889**	1,474	**8,375**
Raw materials	**3,344**	11,311	**31,503**
Securities in commodity	**148**	47	**1,394**
Other inventories	**1,962**	4	**18,483**
	¥16,954	¥28,310	**$159,717**

7. Marketable and Investment Securities:

The following table sets forth the cost and estimated market values of marketable and investment securities, of which the market values are readily determinable, as of March 31, 2000 and 1999:

	Millions of yen		Thousands of U.S. dollars (Note 4)
	2000	1999	**2000**
Marketable securities (current portfolio):			
At cost	**¥ 85**	¥1,307	**$ 801**
At estimated market value	**2,805**	1,753	**26,425**
Investment securities (non-current portfolio):			
At cost	**2,871**	4,275	**27,046**
At estimated market value	**3,361**	4,736	**31,663**

United States Court of Claims.
PHILADELPHIA PARK AMUSEMENT CO.
v.
The UNITED STATES.
No. 312-52.

Nov. 30, 1954.

Suit by corporate taxpayer to recover alleged overpayment of income taxes for years 1944 and 1945. The Court of Claims, Laramore, J., held that where taxpayer which had franchise from city to operate passenger railway in public park exchanged a bridge for extension of its franchise, the exchange was a taxable one and taxpayer was entitled to use, as basis of extension of franchise, which taxpayer later abandoned, the fair market value of extension of franchise on date of exchange, for purposes of determining depreciation and loss due to abandonment of franchise, but since case was not argued on such theory and no evidence as to cost basis had been presented, judgment would be suspended and question of value of extended franchise remanded to court commissioner.

Judgment suspended and case remanded to commissioner.

West Headnotes

[1] Internal Revenue 220 ⚿3480

220 Internal Revenue
220V Income Taxes
220V(I) Deductions
220V(I)5 Depreciation, Depletion, Obsolescence, and Exhaustion
220k3480 k. Subject-Matter in General. Most Cited Cases
(Formerly 220k719)
Franchise obtained from city, to operate passenger railway in public park could, for federal income tax purposes, be amortized over its life by means of depreciation deductions. 26 U.S.C.A. (I.R.C.1954) § 167.

[2] Internal Revenue 220 ⚿3480

220 Internal Revenue
220V Income Taxes
220V(I) Deductions
220V(I)5 Depreciation, Depletion, Obsolescence, and Exhaustion
220k3480 k. Subject-Matter in General. Most Cited Cases
(Formerly 220k719)
Where, five years before original franchise to operate passenger railway in public park expired, city granted taxpayer ten-year extension of franchise to commence when original franchise expired, cost basis of extension of franchise would, for federal income tax purpose, have to be depreciated over remainder of period of original franchise plus ten-year extension. 26 U.S.C.A. (I.R.C.1939) §§ 23(f, *l*), 111-114.

[3] Internal Revenue 220 ⚿3441

220 Internal Revenue
220V Income Taxes
220V(I) Deductions
220V(I)3 Losses
220k3430 Year or Period in Which Deductible
220k3441 k. Worthless Property, Debts or Stock. Most Cited Cases
(Formerly 220k674)
Where franchise is abandoned prior to end of its term, owner is entitled to deduct, for federal income tax purposes, as loss in year of abandonment, undepreciated cost of franchise at that time. 26 U.S.C.A. (I.R.C.1954) § 165.

[4] Internal Revenue 220 ⚿3184

220 Internal Revenue
220V Income Taxes
220V(G) Gains and Losses from Sales and

Exchanges in General
220k3184 k. Exchange of Property. Most Cited Cases
(Formerly 220k463)
Where company holding franchise for operation of passenger railway in public park transferred a bridge to city in exchange for extension of its franchise the exchange was taxable. 26 U.S.C.A. (I.R.C.1939) § 112(b).

[5] Internal Revenue 220 ⚷3196

220 Internal Revenue
220V Income Taxes
220V(G) Gains and Losses from Sales and Exchanges in General
220k3196 k. Market Value. Most Cited Cases
(Formerly 220k463, 220k641)
Income tax gain-or-loss basis of property received in taxable exchange is fair market value of property received. 26 U.S.C.A. (I.R.C.1939) §§ 111-114.

[6] Internal Revenue 220 ⚷3196

220 Internal Revenue
220V Income Taxes
220V(G) Gains and Losses from Sales and Exchanges in General
220k3196 k. Market Value. Most Cited Cases
(Formerly 220k463)
Where taxpayer which had franchise to operate passenger railway in public park transferred a bridge to city in exchange for ten-year extension of franchise, income tax basis of franchise extension would be fair market value of extension on date of exchange. 26 U.S.C.A. (I.R.C.1939) §§ 111-114.

[7] Internal Revenue 220 ⚷4533

220 Internal Revenue
220XXI Assessment of Taxes
220XXI(A) In General
220k4533 k. Valuation of Property. Most Cited Cases
(Formerly 220k1290)
For income tax purposes, value of two properties exchanged in an arms-length transaction are either equal in fact or are presumed to be equal. 26 U.S.C.A. (I.R.C.1939) §§ 111-114.

[8] Internal Revenue 220 ⚷3441

220 Internal Revenue
220V Income Taxes
220V(I) Deductions
220V(I)3 Losses
220k3430 Year or Period in Which Deductible
220k3441 k. Worthless Property, Debts or Stock. Most Cited Cases
(Formerly 220k674)
Where taxpayer which had franchise to operate passenger railway in public park transferred bridge in park to city in (taxable) exchange for extension of franchise, in determining depreciation of, and loss due to abandonment of, franchise, for federal income tax purposes, only if neither market value of extended franchise nor that of bridge could be ascertained would taxpayer be entitled to carry over undepreciated cost of bridge as cost basis of extended franchise. 26 U.S.C.A. (I.R.C.1939) §§ 23(f, *l*), 111-114.

[9] Evidence 157 ⚷113(10)

157 Evidence
157IV Admissibility in General
157IV(A) Facts in Issue and Relevant to Issues
157k113 Value or Market Price of Property
157k113(10) k. Cost of Repairing, Improving, or Replacing Property. Most Cited Cases

Evidence 157 ⚷525

157 Evidence
157XII Opinion Evidence
157XII(B) Subjects of Expert Testimony
157k521 Value

157k525 k. Personal Property. Most Cited Cases

In establishing value, for federal income tax purposes, of old bridge, transferred by taxpayer in taxable exchange, court could properly consider expert testimony on value of comparable bridge, bridge's reproduction cost, its undepreciated cost, and other relevant factors. 26 U.S.C.A. (I.R.C.1939) §§ 23(f, *l*), 111-114.

[10] Internal Revenue 220 ⇐5117

220 Internal Revenue
220XXVIII Refunding Taxes
220XXVIII(B) Actions for Refunds
220XXVIII(B)9 Trial, Judgment and Review
220k5111 Review
220k5117 k. Determination and Disposition. Most Cited Cases
(Formerly 220k2207)

Where it was decided, in action to recover alleged overpayment of income taxes, that proper basis for franchise extension, received in exchange for a bridge, was fair value of property received but no evidence of such value was available, judgment would be suspended and question as to value of extended franchise would be remanded to court commissioner for taking of evidence and filing of report thereon. 26 U.S.C.A. (I.R.C.1939) §§ 23(f, *l*), 111-114.

[11] Internal Revenue 220 ⇐3441

220 Internal Revenue
220V Income Taxes
220V(I) Deductions
220V(I)3 Losses
220k3430 Year or Period in Which Deductible
220k3441 k. Worthless Property, Debts or Stock. Most Cited Cases
(Formerly 220k674)

Failure of taxpayer properly to record taxable transfer in year of transfer or thereafter would not prevent correction of such error to permit taxpayer to take loss due to subsequent abandonment of asset where taxpayer had already lost benefit of depreciation deductions for several years. 26 U.S.C.A. (I.R.C.1939) §§ 23(f, *l*), 111-114.

***185** John C. Reid, Washington, D.C., James S. Y. Ivins and Ivins, Phillips & Barker, Washington, D.C., on the briefs, for plaintiff.

Elizabeth B. Davis, Washington, D.C., H. Brian Holland, Asst. Atty. Gen., Andrew D. Sharpe and Lee A. Jackson, Washington, D.C., on the brief, for defendant.

Before JONES, Chief Judge, and LITTLETON, WHITAKER, MADDEN and LARAMORE, Judges.

LARAMORE, Judge.

The taxpayer corporation sues to recover $42,864.50, with interest thereon, representing alleged overpayment of income taxes for the calendar years 1944 and 1945. The taxpayer employed the accrual method of accounting and reported its income on a calendar year basis. The issue presented in this case is whether or not the taxpayer is entitled to include as a part of the cost of its franchise, for purposes of determining depreciation and loss due to abandonment, the undepreciated cost of a bridge exchanged for a 10-year extension of the franchise. The facts which have been stipulated by the parties may be summarized as follows: The taxpayer's predecessor was granted on July 6, 1889, by the City of Philadelphia, a franchise to construct, operate, and maintain for 50 years a passenger railway in Fairmount Park at its own cost and expense. 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 it at the end of the 50-year term or the 10-year term then in duration. 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.

Pursuant to the franchise the taxpayer's predecessor constructed the bridge in question, commonly known as Strawberry Bridge, over the Schuylkill River ***186** at a cost of $381,000. The bridge was 79 1/2 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 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. The adjusted basis, i.e., the undepreciated or unrecovered cost of Strawberry Bridge at the time of the exchange was $228,852.74. The taxpayer's bookkeeper took depreciation on the bridge for the part of 1934 that taxpayer owned it and promptly wrote the asset off the books by a direct debit to surplus of $228,852.74, without reporting any gain or loss on the exchange or adding the undepreciated cost or fair market value of the bridge to the cost of the franchise. From that time until 1946 the taxpayer's bookkeeper did not record on the taxpayer's books or claim a deduction on its returns for the amortization of this cost. He also failed to take the undisputed deduction for the amortization of the undepreciated portion, $50,000, of the original cost of the franchise.

In 1946 the taxpayer arranged with a bus company to give passenger service to its amusement park, ceased operation of the railway, and abandoned its franchise. In its 1946 tax return the taxpayer claimed a loss due to abandonment of the railroad of $336,380.04, $74,445.89 of which was claimed to represent the undepreciated cost of the franchise. This produced a $128,897.97 net loss for the year 1946, and taxpayer claimed a net operating loss carryback to 1944 and 1945 under section 122(b) of the Code, 26 U.S.C.A. § 122(b).

On December 15, 1947, the taxpayer filed a claim for refund of 1944 taxes in the amount of $6,087.28 based on a claimed depreciation deduction of $15,218.21. This claim was founded upon the ground that the undepreciated cost of Strawberry Bridge, $228,852.74, was the cost of the 10-year extension of its franchise and, therefore, should be amortized over the remaining life of the franchise. On December 30, 1948, taxpayer filed a second claim for refund of 1944 income taxes. This claim was in the amount of $58,791.91 and was predicated on the following grounds: (1) net operating loss carryback deduction of $128,897.97 from 1946, (2) depreciation deduction of $3,816.66 as the 1944 proportion of the cost basis of taxpayer's original franchise, and (3) a repetition of the first claim for refund. On October 26, 1950, the Commissioner of Internal Revenue allowed $55,036.71 of the net operating loss carryback and $3,333.33 of the $3,816.66 claim for depreciation of the original cost of the franchise, but denied taxpayer's first claim for refund for 1944 and the repetition thereof in the second claim for a $15,218.21 depreciation deduction based upon the undepreciated cost of Strawberry Bridge. The Commissioner refunded to the taxpayer, on account of its 1944 taxes, $22,014.69 with interest thereon.

***187** On December 30, 1948, taxpayer filed a claim for refund of income taxes for the year 1945 in the amount of $6,087.28, claiming a deduction of $3,816.66 as the depreciation deduction for the amortization of the cost of its original franchise and $15,218.21 as the depreciation deduction for the amortization of the cost of the 10-year extension of its franchise. On October 26, 1950, the Commissioner allowed $3,333.33 of the claimed deduction for the original cost of the franchise and, accordingly, refunded to taxpayer $1,282.05 with interest thereon, but denied the balance of the claim.

In its petition the taxpayer alleged that the Commissioner's rejection of all of its first claim for 1944, part of its second claim for 1944, and part of its claim for 1945 was erroneous. The defendant raised the question of statute of limitations in respect to the part of the taxpayer's claim that pertained to the allowance of a deduction for depreciation of the original cost of the franchise for the year 1944. The taxpayer claimed $3,816.16, whereas the Commissioner allowed only $3,333.33. The difference is a result of the Commissioner's amortization of the original cost of the franchise over the period beginning on the date the franchise was granted as opposed to taxpayer's desire to have it amortized over the period beginning on the date of the start of operation of the railway. This issue apparently has been abandoned by both parties inasmuch as no mention was made of it in the briefs or on oral argument. Therefore, we are only concerned with the cost basis, if any, of the 10-year extension of taxpayer's franchise and the tax consequences thereof for the years 1944, 1945, and 1946.

[1-3] It is clear that the cost of this type franchise can be amortized over its life by the taking of depreciation deduction under section 23(l) [FN1] of the Code. See Regulation 111, section 29.23(1)-3; Cleveland Railway Co. v. Commissioner, 36 B.T.A. 208, and cases cited therein. Therefore, the cost basis, if any, of the 10-year extension of the franchise should be depreciated over the remainder of the old term and over the new term. East Kauai Water Co. v. Commissioner, 11 T.C. 1014, and cases cited therein. It is also clear that when a franchise is abandoned prior to the end of its term the owner is entitled to deduct, under section 23(f)[FN2] of the Code, as a loss in the year of abandonment, the undepreciated cost of the franchise at that time. Elston Co., to Use and Benefit of U.S. Brewing Co. v. United States, 21 F.Supp. 267, 86 Ct.Cl. 136, and cases cited therein.

FN1. Section 23(l) provides: (In computing net income there shall be allowed as deductions:) 'Depreciation. A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)-(1) of property used in the trade or business, or (2) of property held for the production of income.' 26 U.S.C.A. § 23(l).

FN2. Section 23(f) provides: (In computing net income there shall be allowed as deductions:) 'Losses by corporations. In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.'

[4] This brings us to the question of what is the cost basis of the 10-year extension of taxpayer's franchise. Although defendant contends that Strawberry Bridge was either worthless or not 'exchanged' for the 10-year extension of the franchise, we believe 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 of the other. The taxpayer, however, has failed to show that the exchange was one that falls within the nonrecognition provisions of section 112(b) of the Code and, therefore, it was a taxable exchange under section 112(a)[FN3] of the Code.

FN3. Section 112(a) provides: 'General Rule. Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.' 26 U.S.C.A. § 112.

***188** The gain or loss, whichever the case may have been, should have been recognized, and the cost basis under section 113(a)FN4 of the Code, of the 10-year extension of the franchise was the cost to the taxpayer. The succinct statement in section 113(a) 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. FN5 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. FN6 As will be seen from the cases and some of the Commissioner's rulings FN7 the Commissioner's position has not been altogether consistent on this question. The view that 'cost' is the fair market value of the property given is predicated on the theory that the cost to the taxpayer is the economic value relinquished. The view that 'cost' is the fair market value of the property received is based upon the theory that the term 'cost' is a tax concept and must be considered in the light of the designed interrelationship of sections 111, 112, 113, and 114, 26 U.S.C.A. § 114, and the prime role that the basis of property plays in determining tax liability. We believe that when the question is considered in the latter context that the cost basis of the property received in a taxable exchange is the fair market value of the property received in the exchange.

FN4. Section 113(a) provides: 'Basis, (unadjusted) of property. The basis of property shall be the cost of such property; except that * * *.' 26 U.S.C.A. § 113.

FN5. 1 Montgomery, Federal Taxes, Corporations and Partnerships (1952-53) 352; 1 P-H 10, 506, 1954; Budd International Corp. v. Commissioner, 3 Cir., 143 F.2d 784; Forstmann v. Rogers, 3 Cir., 128 F.2d 126; Champlin Refining Co. v. Commissioner, 10 Cir., 123 F.2d 202; Estate of Isadore L. Myers v. Commissioner, 1 T.C. 100; and the cases there cited. It should be noted that many of the statements made in the above cited authorities were made in connection with exchanges of property where the values were equal, presumed to be equal or the specific question was not disputed and therefore there would have been no difference in result.

FN6. Moroney and Colgan, Gain or Loss on Sale or Exchange, Fundamentals of Federal Taxation, Practicing Law Institute (1946); Rabkin & Johnson, Federal Income Gift and Estate Taxation, S3 Sec. 2; Greenbaum, The Basis of Property Shall Be the Cost of Such Property; How is Cost Defined?, 3 Tex.L.Rev. 351 1948); Bodell v. Commissioner, 1 Cir., 154 F.2d 407; Commissioner of Internal Revenue v. Lincoln-Boyle Ice Co., 7 Cir., 93 F.2d 26; Hillyer, Edwards, Fuller, Inc. v. United States, D.C.E.D.La., 52 F.2d 742; Feathers v. Commissioner, 8 T.C. 376; Estate of Isadore L. Myers v. Commissioner, 1 T.C. 100 (concurring opinion); and the cases there cited.

FN7. Compare I.T. 2212, IV-2 C.B. 118 with I.T. 3523, 1941-2 C.B. 124 and the Commissioner's equivocal acquiescence in Estate of Isadore L. Myers case, supra, 1943-1 C.B. 17.

[5] 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 re-

ceived 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 therefor, 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 ***189** 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.

[6][7] Therefore, the cost basis of the 10-year extension of the franchise was its fair market value on August 3, 1934, the date of the exchange. The determination of whether the cost basis of the property received is its fair market value or the fair market value of the property given in exchange therefor, although necessary to the decision of the case, is generally not of great practical significance because the value of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal.[FN8] The record in this case indicates that the 1934 exchange was an arms-length transaction and, therefore, if the value of the extended franchise cannot be determined with reasonable accuracy, it would be reasonable and fair to assume that the value of Strawberry Bridge was equal to the 10-year extension of the franchise. The fair market value of the 10-year extension of the franchise should be established but, if that value cannot be determined with reasonable certainty, the fair market value of Strawberry Bridge should be established and that will be presumed to be the value of the extended franchise. This value cannot be determined from the facts now before us since the case was prosecuted on a different theory.

FN8. See footnotes 5 and 6.

[8][9] The taxpayer contends that the market value of the extended franchise or Strawberry Bridge could not be ascertained and, therefore, it should be entitled to carry over the undepreciated cost basis of the bridge as the cost of the extended franchise under section 113(b)(2).[FN9] If the value of the extended franchise or bridge cannot be ascertained with a reasonable degree of accuracy, the taxpayer is entitled to carry over the undepreciated cost of the bridge as the cost basis of the extended franchise. Helvering v. Tex-Pen Oil Co., 300 U.S. 481, 499, 57 S.Ct. 569, 81 L.Ed. 755; Gould Securities Co. v. United States, 2 Cir., 96 F.2d 780. However, it is only in rare and extraordinary cases that the value of the property exchanged cannot be ascertained with reasonable accuracy. We are presently of the opinion that either the value of the extended franchise or the bridge can be determined with a reasonable degree of accuracy. Although the value of the extended franchise may be difficult or impossible to ascertain because of the nebulous and intangible characteristics inherent in such property, the value of the bridge is subject to more exact measurement. Consideration may be given to expert testimony on the value of comparable bridges, Strawberry Bridge's reproduction cost and its undepreciated cost, as well as other relevant factors.

FN9. Section 113(b)(2) provides: 'Substituted basis. The term 'substituted basis' as used in this subsection means a basis determined under any provision of subsection (a) of this section or under any corresponding provision of a prior income tax law, providing that the basis shall be determined-(A) by reference to the basis in the hands of a transferor, donor, or grantor, or (B) by reference to other property held at any time by the person for whom the basis is to be determined.'

[10] Therefore, because we deem it equitable, judgment should be suspended and the question of the value of the extended franchise on August 3, 1934, should be remanded to the Commissioner of this court for the taking of evidence and the filing of a

report thereon.

[11] The failure of taxpayer to properly record the transaction in 1934 and thereafter does not prevent the correction of the error, especially under the circumstances of this case. ***190**Countway v. Commissioner, 1 Cir., 127 F.2d 69. The taxpayer has lost not only the depreciation deductions for the years 1935 to 1944 of the cost of its original franchise, but also the benefit of the depreciation deduction for the cost of the extended franchise, even though the basis of the former was and the latter will be reduced by the amount of depreciation that should have been taken for this period. See section 113(b) (1)(B) of the Internal Revenue Code.

In the cases cited by taxpayer relating to losses claimed upon obtaining licenses and leases, or the extension or renewal thereof, the question presented was whether the amount involved was part of the cost of the license or lease and, therefore, should be capitalized and amortized over their life, or whether they were losses or expenses that should be deducted in the taxable year. In those cases either the amount in question was the actual cost, or property was not exchanged, or fair market value was not an issue. Those cases deal with different problems and are not applicable here.

We, therefore, conclude that the 1934 exchange was a taxable exchange and that the taxpayer is entitled to use as the cost basis of the 10-year extension of its franchise its fair market value on August 3, 1934, for purposes of determining depreciation and loss due to abandonment, as indicated in this opinion.

Accordingly, judgment will be suspended and the question of the value of the extended franchise on August 3, 1934, is remanded to the Commissioner of this court for the taking of evidence and the filing of a report thereon.

JONES, Chief Judge, and MADDEN, WHITAKER, and LITTLETON, Judges, concur.

CT.CL. 1954.
Philadelphia Park Amusement Co. v. U.S.
130 Ct.Cl. 166, 126 F.Supp. 184, 54-2 USTC P 9697, 46 A.F.T.R. 1293

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Supreme Court of the United States
UNITED STATES, Petitioner,
v.
Thomas Crawley DAVIS et al.
Thomas Crawley DAVIS et al., Petitioners,
v.
UNITED STATES.
Nos. 190, 268.

Argued March 28, 1962.
Decided June 4, 1962.

Action involving tax consequences of a transfer of appreciated property by husband to former wife pursuant to property settlement agreement, and deductibility of his payment of wife's legal expenses in connection therewith. The Court of Claims, 152 Ct.Cl. 805, 287 F.2d 168, held there was no taxable gain on the transfer and that the fees were not deductible, and certiorari was granted. The Supreme Court, Mr. Justice Clark, held that husband's transfer of stock to his wife constituted a taxable event, and the gain measured by the value of the stock at the date of its transfer was taxable.

Reversed in part and affirmed in part.

West Headnotes

[1] Husband and Wife 205 49.2(5)

205 Husband and Wife
205III Conveyances, Contracts, and Other Transactions Between Husband and Wife
205k49 Gifts
205k49.2 Gift by Husband to or for Wife
205k49.2(4) What Constitutes
205k49.2(5) k. In General. Most Cited Cases
(Formerly 205k491/2(3))
Property transferred by husband to wife pursuant to property settlement agreement in exchange for release of marital rights by wife did not constitute a "gift".

[2] Internal Revenue 220 3192

220 Internal Revenue
220V Income Taxes
220V(G) Gains and Losses from Sales and Exchanges in General
220k3192 k. Transfer Pursuant to Divorce Decree or Settlement. Most Cited Cases
(Formerly 220k440)
Husband's transfer of stock, which had appreciated in value, to his wife pursuant to property settlement, agreement executed prior to divorce, constituted a taxable event, and the husband's gain measured by value of stock at date of its transfer was taxable. 12 Del.C. §§ 502, 512, 901, 904, 905; 13 Del.C. § 1531; 26 U.S.C.A. (I.R.C.1954) §§ 61(a), 1001(a, b), 1002.

[3] Courts 106 90(4)

106 Courts
106II Establishment, Organization, and Procedure
106II(G) Rules of Decision
106k88 Previous Decisions as Controlling or as Precedents
106k90 Decisions of Same Court or Co-Ordinate Court
106k90(4) k. Construction and Operation of Statutes. Most Cited Cases
Unanimity of views in support of position that transfer of appreciated property by husband to wife as part of property settlement agreement constitutes a taxable event and represents a reasonable construction of an ambiguous statute will not lightly be put aside. 26 U.S.C.A.(I.R.C.1054) § 1001(a, b).

[4] Internal Revenue 220 3192

220 Internal Revenue
220V Income Taxes
220V(G) Gains and Losses from Sales and Exchanges in General

220k3192 k. Transfer Pursuant to Divorce Decree or Settlement. Most Cited Cases
(Formerly 220k440)
Market value of property transferred by husband to wife as part of property settlement agreement is the wife's tax basis for the property received. 26 U.S.C.A. (I.R.C.1954) §§ 61(a), 1001, 1002.

[5] Internal Revenue 220 ⚿3328.1

220 Internal Revenue
220V Income Taxes
220V(I) Deductions
220V(I)2 Expenses
220k3328 Attorney Fees
220k3328.1 k. In General. Most Cited Cases
(Formerly 220k3328, 220k543)
Husband was not entitled to a tax deduction for fee paid his wife's attorney for tax advice given in relation to property settlement agreement. 26 U.S.C.A. (I.R.C.1954) § 212(3).
****1191 *65** I. Henry Kutz and Harold C. Wilkenfeld, Washington, D.C., for petitioner in No. 190 and for respondent in No. 268.

Converse Murdoch, Philadelphia, Pa., for respondents in No. 190 and for petitioners in No. 268.

***66** Mr. Justice CLARK delivered the opinion of the Court.

These cases involve the tax consequences of a transfer of appreciated property by Thomas Crawley Davis[FN1] to his former wife pursuant to a property settlement agreement executed prior to divorce, as well as the deductibility of his payment of her legal expenses in connection therewith. The Court of Claims upset the Commissioner's determination that there was taxable gain on the transfer but upheld his ruling that the fees paid the wife's attorney were not deductible. 152 Ct.Cl. 805, 287 F.2d 168. We granted certiorari on a conflict in the Courts of Appeals and the Court of Claims on the taxability of such transfers.[FN2] 368 U.S. 813, 82 S.Ct. 60, 7 L.Ed.2d 21. We have decided that the taxpayer did have a taxable gain on the transfer and that the wife's attorney's fees were not deductible.

FN1. Davis' present wife, Grace Ethel Davis, is also a party to these proceedings because a joint return was filed in the tax year in question.

FN2. The holding in the instant case is in accord with Commissioner of Internal Revenue v. Marshman, 279 F.2d 27 (C.A.6th Cir. 1960), but is contra to the holdings in Commissioner of Internal Revenue v. Halliwell, 131 F.2d 642 (C.A.2d Cir. 1942), and Commissioner of Internal Revenue v. Mesta, 123 F.2d 986 (C.A.3d Cir. 1941).

In 1954 the taxpayer and his then wife made a voluntary property settlement and separation agreement calling for support payments to the wife and minor child in addition to the transfer of certain personal property to the wife. Under Delaware law all the property transferred was that of the taxpayer, subject to certain statutory marital rights of the wife including a right of intestate succession and a right upon divorce to a share of the husband's property.[FN3] Specifically as a 'division in settlement of their property' the taxpayer agreed to transfer to his wife, inter alia, 1,000 shares of stock in the E. I. du Pont de Nemours & Co. The then Mrs. Davis agreed to ***67** accept this division 'in full settlement and satisfaction of any and all claims and rights against the husband whatsoever (including but not by way of limitation, dower and all rights under the laws of testacy and intestacy) * * *.' Pursuant to the above agreement which had been incorporated into the divorce decree, one-half of this stock was delivered in the tax year involved, 1955, and the balance thereafter. Davis' cost basis for the 1955 transfer was $74,775.37, and the fair market value of the 500 shares there transferred was $82,250. The taxpayer also agreed orally to pay the wife's legal expenses, and in 1955 he made payments to the wife's attorney, including $2,500 for services concerning tax matters relative to the property settlement.

FN3. 12 Del.Code Ann. (Supp.1960) s 512; 13 Del.Code Ann. s 1531. In the case of realty, the wife in addition to the above has rights of dower. 12 Del.Code Ann. ss 502, 901, 904, 905.

I.

The determination of the income tax consequences of the stock transfer described above is basically a two-step analysis: (1) Was the transaction a taxable event? (2) If so, how much taxable gain resulted therefrom? Originally the Tax Court (at that time the Board of Tax Appeals) held that the accretion to property transferred pursuant to a divorce settlement could not be taxed as ****1192** capital gain to the transferor because the amount realized by the satisfaction of the husband's marital obligations was indeterminable and because, even if such benefit were ascertainable, the transaction was a nontaxable division of property. Mesta v. Commissioner, 42 B.T.A. 933 (1940); Halliwell v. Commissioner, 44 B.T.A. 740 (1941). However, upon being reversed in quick succession by the Courts of Appeals of the Third and Second Circuits, Commissioner of Internal Revenue v. Mesta, 123 F.2d 986 (C.A.3d Cir. 1941); Commissioner of Internal Revenue v. Halliwell, 131 F.2d 642 (C.A.2d Cir. 1942), the Tax Court accepted the position of these courts and has continued to apply these views in appropriate cases since that time, ***68**Hall v. Commissioner, 9 T.C. 53 (1947); Patino v. Commissioner, 13 T.C. 816 (1949); Estate of Stouffer v. Commissioner, 30 T.C. 1244 (1958); King v. Commissioner, 31 T.C. 108 (1958); Marshman v. Commissioner, 31 T.C. 269 (1958). In Mesta and Halliwell the Courts of Appeals reasoned that the accretion to the property was 'realized' by the transfer and that this gain could be measured on the assumption that the relinquished marital rights were equal in value to the property transferred. The matter was considered settled until the Court of Appeals for the Sixth Circuit, in reversing the Tax Court, ruled that, although such a transfer might be a taxable event, the gain realized thereby could not be determined because of the impossibility of evaluating the fair market value of the wife's marital rights. Commissioner of Internal Revenue v. Marshman, 279 F.2d 27 (1960). In so holding that court specifically rejected the argument that these rights could be presumed to be equal in value to the property transferred for their release. This is essentially the position taken by the Court of Claims in the instant case.

II.

[1] We now turn to the threshold question of whether the transfer in issue was an appropriate occasion for taxing the accretion to the stock. There can be no doubt that Congress, as evidenced by its inclusive definition of income subject to taxation, i.e., 'all income from whatever source derived, including * * * (g)ains derived from dealings in property,'[FN4] intended that the economic growth of this stock be taxed. The problem confronting us is simply when is such accretion to be taxed. Should the economic gain be presently assessed against taxpayer, or should this assessment await a subsequent transfer of the property by the wife? The controlling ***69** statutory language, which provides that gains from dealings in property are to be taxed upon 'sale or other disposition,'[FN5] is too general to include or exclude conclusively the transaction presently in issue. Recognizing this, the Government and the taxpayer argue by analogy with transactions more easily classified as within or without the ambient of taxable events. The taxpayer asserts that the present disposition is comparable to a nontaxable division of property between two co-owners,[FN6] while the Government contends it more resembles****1193** a taxable transfer of property in exchange for the release of an independent legal obligation. Neither disputes the validity of the other's starting point.

FN4. Internal Revenue Code of 1954, s 61(a), 26 U.S.C.A. s 61(a).

FN5. Internal Revenue Code of 1954, ss 1001, 1002, 26 U.S.C.A. ss 1001, 1002.

FN6. Any suggestion that the transaction in question was a gift is completely unrealistic. Property transferred pursuant to a negotiated settlement in return for the release of admittedly valuable rights is not a gift in any sense of the term. To intimate that there was a gift to the extent the value of the property exceeded that of the rights released not only invokes the erroneous premise that every exchange not precisely equal involves a gift but merely raises the measurement problem discussed in Part III, infra, 370 U.S., p. 71, 82 S.Ct., p. 1194. Cases in which this Court has held transfers of property in exchange for the release of marital rights subject to gift taxes are based not on the premise that such transactions are inherently gifts but on the concept that in the contemplation of the gift tax statute they are to be taxed as gifts. Merrill v. Fahs, 324 U.S. 308, 65 S.Ct. 655, 89 L.Ed. 963 (1945); Commissioner of Internal Revenue v. Wemyss, 324 U.S. 303, 65 S.Ct. 652, 89 L.Ed. 958 (1945); see Harris v. Commissioner, 340 U.S. 106, 71 S.Ct. 181, 95 L.Ed. 111 (1950). In interpreting the particular income tax provisions here involved, we find ourselves unfettered by the language and considerations ingrained in the gift and estate tax statutes. See Farid-EsSultaneh v. Commissioner, 160 F.2d 812 (C.A.2d Cir. 1947).

[2] In support of his analogy the taxpayer argues that to draw a distinction between a wife's interest in the property of her husband in a common-law jurisdiction such as Delaware and the property interest of a wife in a typical community property jurisdiction would commit a double sin; for such differentiation would depend upon 'elusive ***70** subtle casuistries which * * * possess no relevance for tax purposes,' Helvering v. Hallock, 309 U.S. 106, 118, 60 S.Ct. 444, 450, 84 L.Ed. 604 (1940), and would create disparities between common-law and community property jurisdictions in contradiction to Congress' general policy of equality between the two. The taxpayer's analogy, however, stumbles on its own premise, for the inchoate rights granted a wife in her husband's property by the Delaware law do not even remotely reach the dignity of co-ownership. The wife has no interest-passive or active-over the management or disposition of her husband's personal property. Her rights are not descendable, and she must survive him to share in his intestate estate. Upon dissolution of the marriage she shares in the property only to such extent as the court deems 'reasonable.' 13 Del.Code Ann. s 1531(a). What is 'reasonable' might be ascertained independently of the extent of the husband's property by such criteria as the wife's financial condition, her needs in relation to her accustomed station in life, her age and health, the number of children and their ages, and the earning capacity of the husband. See, e.g., Beres v. Beres, 2 Storey 133, 52 Del. 133, 154 A.2d 384 (1959).

This is not to say it would be completely illogical to consider the shearing off of the wife's rights in her husband's property as a division of that property, but we believe the contrary to be the more reasonable construction. Regardless of the tags, Delaware seems only to place a burden on the husband's property rather than to make the wife a part owner thereof. In the present context the rights of succession and reasonable share do not differ significantly from the husband's obligations of support and alimony. They all partake more of a personal liability of the husband than a property interest of the wife. The effectuation of these marital rights may ultimately result in the ownership of some of the husband's ***71** property as it did here, but certainly this happenstance does not equate the transaction with a division of property by co-owners. Although admittedly such a view may permit different tax treatment among the several States, this Court in the past has not ignored the differing effects on the federal taxing scheme of substantive differences between community property and common-law systems. E.g., Poe v. Seaborn, 282 U.S. 101, 51 S.Ct. 58, 75 L.Ed. 239 (1930). To be sure Congress has seen fit to alleviate this disparity in many areas, e.g., Revenue Act of 1948, 62 Stat. 110, but in other areas the facts of life are still with us.

[3] Our interpretation of the general statutory language is fortified by the long-standing administrative practice as sounded and formalized by the settled state of law in the lower courts. The Commissioner's position was adopted in the early 40's by the Second and Third ****1194** Circuits and by 1947 the Tax Court had acquiesced in this view. This settled rule was not disturbed by the Court of Appeals for the Sixth Circuit in 1960 or the Court of Claims in the instant case, for these latter courts in holding the gain indeterminable assumed that the transaction was otherwise a taxable event. Such unanimity of views in support of a position representing a reasonable construction of an ambiguous statute will not lightly be put aside. It is quite possible that this notorious construction wsa relied upon by numerous taxpayers as well as the Congress itself, which not only refrained from making any changes in the statutory language during more than a score of years but re-enacted this same language in 1954.

III.

Having determined that the transaction was a taxable event, we now turn to the point on which the Court of Claims balked, viz., the measurement of the taxable gain realized by the taxpayer. The Code defines the taxable ***72** gain from the sale or disposition of property as being the 'excess of the amount realized therefrom over the adjusted basis * * *.' I.R.C. (1954) s 1001(a). The 'amount realized' is further defined as 'the sum of any money received plus the fair market value of the property (other than money) received.' I.R.C. (1954) s 1001(b). In the instant case the 'property received' was the release of the wife's inchoate marital rights. The Court of Claims, following the Court of Appeals for the Sixth Circuit, found that there was no way to compute the fair market value of these marital rights and that it was thus impossible to determine the taxable gain realized by the taxpayer. We believe this conclusion was erroneous.

It must be assumed, we think, that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged. There was no evidence to the contrary here. Absent a readily ascertainable value it is accepted practice where property is exchanged to hold, as did the Court of Claims in Philadelphia Park Amusement Co. v. United States, 126 F.Supp. 184, 189, 130 Ct.Cl. 166, 172 (1954), that the values 'of the two properties exchanged in an arms-length transaction are either equal in fact or are presumed to be equal.' Accord, United States v. General Shoe Corp., 282 F.2d 9 (C.A.6th Cir. 1960); International Freighting Corp. v. Commissioner, 135 F.2d 310 (C.A.2d Cir. 1943). To be sure there is much to be said of the argument that such an assumption is weakened by the emotion, tension and practical necessities involved in divorce negotiations and the property settlements arising therefrom. However, once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax ***73** consequences. Cf. Helvering v. Safe Deposit & Trust Co., 316 U.S. 56, 67, 62 S.Ct. 925, 930, 86 L.Ed. 1266 (1942).

[4] Moreover, if the transaction is to be considered a taxable event as to the husband, the Court of Claims' position leaves up in the air the wife's basis for the property received. In the context of a taxable transfer by the husband,[FN7] all indicia point to a 'cost' basis for this property in the hands of the wife.[FN8] Yet under the Court of Claims' position her cost for this property, i.e., the value of ****1195** the marital rights relinquished therefor, would be indeterminable, and on subsequent disposition of the property she might suffer inordinately over the

Commissioner's assessment which she would have the burden of proving erroneous, Commissioner of Internal Revenue v. Hansen, 360 U.S. 446, 468, 79 S.Ct. 1270, 3 L.Ed.2d 1360 (1959). Our present holding that the value of these rights is ascertainable eliminates this problem; for the same calculation that determines the amount received by the husband fixes the amount given up by the wife, and this figure, i.e., the market value of the property transferred by the husband, will be taken by her as her tax basis for the property received.

FN7. Under the present administrative practice, the release of marital rights in exchange from property or other consideration is not considered a taxable event as to the wife. For a discussion of the difficulties confronting a wife under a contrary approach, see Taylor and Schwartz, Tax Aspects of Marital Property Agreements, 7 Tax L.Rev. 19, 30 (1951); Comment, The Lump Sum Divorce Settlement as a Taxable Exchange, 8 U.C.L.A.L.Rev. 593, 601-602 (1961).

FN8. Section 1012 of the Internal Revenue Code of 1954, 26 U.S.C.A. s 1012 provides that: 'The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). * * *'

Finally, it must be noted that here, as well as in relation to the question of whether the event is taxable, we *74 draw support from the prior administrative practice and judicial approval of that practice. See 370 U.S., p. 71, 82 S.Ct., p. 1193, supra. We therefore conclude that the Commissioner's assessment of a taxable gain based upon the value of the stock at the date of its transfer has not been shown erroneous.[FN9]

FN9. We do not pass on the soundness of the taxpayer's other attacks upon this determination, for these contentions were not presented to the Commissioner or the Court of Claims.

IV.

[5] The attorney-fee question is much simpler. It is the customary practice in Delaware for the husband to pay both his own and his wife's legal expenses incurred in the divorce and the property settlement. Here petitioner paid $5,000 of such fees in the taxable year 1955 earmarked for tax advice in relation to the property settlement. One-half of this sum went to the wife's attorney. The taxpayer claimed that under s 212(3) of the 1954 Code, 26 U.S.C.A. s 212(3), which allows a deduction for the 'ordinary and necessary expenses paid * * * in connection with the determination, collection, or refund of any tax,' he was entitled to deduct the entire $5,000. The Court of Claims allowed the $2,500 paid taxpayer's own attorney but denied the like amount paid the wife's attorney. The sole question here is the deductibility of the latter fee; the Government did not seek review of the amount taxpayer paid his own attorney, and we intimate no decision on that point. As to the deduction of the wife's fees, we read the statute, if applicable to this type of tax expense, to include only the expenses of the taxpayer himself and not those of his wife. Here the fees paid her attorney do not appear to be 'in connection with the determination, collection, or refund' of any tax of the taxpayer. As the Court of Claims found, the wife's attorney 'considered the problems from the standpoint of his client alone. Certainly*75 then it cannot be said that * * * (his) advice was directed to plaintiff's tax problems * * *.' 152 Ct.Cl 805, 287 F.2d, at 171. We therefore conclude, as did the Court of Claims, that those fees were not a deductible item to the taxpayer.

Reversed in part and affirmed in part.

Mr. Justice FRANKFURTER took no part in the decision of these cases.

Mr. Justice WHITE took no part in the consideration or decision of these cases.
U.S.Ct.Cl. 1962.
U.S. v. Davis
370 U.S. 65, 82 S.Ct. 1190, 8 L.Ed.2d 335, 9 A.F.T.R.2d 1625, 62-2 USTC P 9509, 1962-2 C.B. 15

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Tax Court of the United States.
MOORE-MCCORMACK LINES, INC., PETITIONER,
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
Docket No. 2887-62.

Filed August 27, 1965.

***745** Paul Edgar Swartz, William E. Stockhausen, and Harold H. Meyers, for the petitioner.

George T. Rita, for the respondent.

1. Petitioner purchased 10 ships from a single seller by the issuance of 300,000 shares of its own previously unissued stock. The stock so issued constituted 13 percent of petitioner's outstanding stock thereafter. Two of the ships so purchased were immediately resold. Held, the basis to petitioner of the two ships resold is determined by the fair market value of such stock issued to purchase them; the fair market value of such stock was $30 per share.

2. Held: The cost basis, for purposes of computing depreciation of various other vessels, purchased in 1941, is the 'statutory sales Rice' as calculated under section 9 of the Merchant Ship Sales Act of 1946. Waterman Steamship Corporation v. United States, 381 U.S. 252 (1965), controls.

***746** HOYT, Judge:

Respondent determined a deficiency in income tax against petitioner in the amount of $663,519.48 for the taxable year 1957.

The issues for decision are:

(1) What was the cost basis, for purposes of computing the correct amount of gain on sale, of two ships acquired by petitioner in 1957 for cash and stock, and resold in the same year?

(2) Is the cost basis, for purposes of computing depreciation, of various vessels purchased in 1941 the original purchase price as readjusted under section 9 of the Merchant Ship Sales Act of 1946 or the 'statutory sales price' as calculated under the Act?

FINDINGS OF FACT

Some of the facts have been stipulated and the stipulation and exhibits attached thereto are hereby incorporated by reference.

Petitioner is a Delaware corporation with its principal office in New York City. It keeps its books and files its income tax returns on the accrual basis. It filed its 1957 calendar year income tax return with the district director, Manhattan District. Petitioner is a publicly owned shipping company whose common stock is, and was at all times here pertinent, traded on the New York Stock Exchange.

FACTS COMMON TO THIS CASE AND TO DOCKET NO. 3105-62 SEAS SHIPPING CO.

On March 1, 1957, Moore-McCormack Lines, Inc., (hereinafter referred to as Mooremac), entered into a contract with Seas Shipping Co., Inc. (hereinafter sometimes referred to as Seas), which operated a shipping fleet known as the Robin Line. This contract provided for the purchase by Mooremac from Seas of 12 vessels for a total purchase price of $17 million, payable $3,200,000 in cash, $4,800,000 in cash or promissory notes at option of Mooremac, and $9 million by 300,000 shares of Mooremac's common stock. The vessels were described in the contract as follows:

Name	*Type*	*Year built*

SS *Robin Locksley*	C-2S	1941
SS *Robin Wentley*	C-2S	1941
SS *Robin Tuxford*	C-2S	1941
SS *Robin Shewood*	C-2S	1941
SS *Robin Kettering*	C-2S	1941
SS *Robin Doncaster*	C-2S	1941
SS *Robin Goodfellow*	C-3	1945
SS *Robin Gray*	C-3	1943
SS *Robin Hood*	C-3	1945
SS *Robin Kirk*	C-3	1943
SS *Robin Mowbray*	C-3	1943
SS *Robin Trent*	C-3	1943

*747 Pertinent provisions of the contract are set forth below:

5. Delivery of Vessels: Each Vessel shall be delivered to BUYER * * * promptly on completion of its voyage in progress on April 15, 1957. * * *

7. Purchase Price and Payment Thereof:

(a) As and for the purchase price of the Vessels, the BUYER shall pay and deliver to SELLER the follow- ing:

(1) Cash . . . . $3,200,000.

(2) Three Hundred Thousand (300,000) shares of BUY-ER'S duly authorized Common Stock (par value $12 per share).

(3) At BUYER'S option, cash or promissory notes of BUYER, as more particularly described hereinafter, in the amount of $4,800,000. By mutual agreement some or all of said sum of $4,800,000 may be paid in additional shares of BUYER'S duly authorized Common Stock (par value $12 per share).

(b) The purchase price shall be payable as follows:

(1) On delivery of the Robin Goodfellow, there shall be paid in cash out of BUYER'S Capital Reserve Fund the sum of $1,600,000 for such Vessel.

(2) On delivery of the Robin Hood, there shall be paid in cash out of BUYER'S Capital Reserve Fund the sum of $1,600,000 for such Vessel.

(3) Upon delivery of the first of the Vessels to be delivered, BUYER will issue and deposit in escrow with The Chase Manhattan Bank, New York, New York * * * Three Hundred Thousand (300,000) shares of its duly authorized Common Stock. * * *

(4) Such escrow agreement shall, among other things, provide that on receipt by the Bank of notice from BUYER and SELLER jointly that one or more of the Vessels has been delivered by SELLER and accepted by BUYER, said Three Hundred Thousand (300,000) shares of Common Stock shall be delivered by the Bank to SELLER or upon its written order in payment for the Vessels of the C-2S type unless excepted as provided in Article 10 hereof, upon delivery thereof, and, to the extent that such shares shall not be deliverable in payment for Vessels of the C-2S type as hereinabove provided, in payment for Vessels of the C-3 type (except the Robin Hood and the Robin Goodfellow) in the order of their delivery.

(5) For purposes of paragraph (4) above, said Three Hundred Thousand (300,000) shares of Common Stock shall be delivered to SELLER or on its written order at the rate of one full share thereof for each $30, or fraction thereof, of value of the Vessels hereinafter set forth opposite their respective names, as follows:

	Name of vessel	Value
SS *Robin*	*Locksley*	$1,266,667
"	*Wentley*	1,266,677
"	*Tuxford*	1,266,667
"	*Sherwood*	1,266,667
"	*Kettering*	1,266,666
"	*Doncaster*	1,266,666
"	*Gray*	1,550,000
"	*Kirk*	1,550,000
"	*Mowbray*	1,550,000
"	*Trent*	1,550,000
		[13,800,000]

***748** (6) Subject to the final sentence of paragraph (a)(3) of this Article 7, the balance of the purchase price of the Vessels shall be payable, at BUYER's option, either in cash or in serial promissory notes of BUYER, or partly in cash and partly in such notes. * * *

8. Conditions to Sale: Anything herein to the contrary notwithstanding the purchase herein provided for is and shall be subject to full compliance on or before April 15, 1957 with the following conditions precedent:

(a) Approval by the Federal Maritime Board and/or Maritime Administration of the sale of the Vessels on the terms and conditions herein contained:

(g) * * * (T)he listing by the New Stock Exchange of the Three Hundred Thousand (300,000) shares of such Common Stock issuable in payment of part of the purchase price as herein provided;

10. Exception of Vessels from Sale: At the option of BUYER, exercisable by written notice delivered to SELLER prior to delivery of the first Vessel hereunder, there shall be excepted from the purchase herein provided for the SS Robin Kettering or the SS Robin Doncaster, or both. In such event, any such Vessel so designated shall be excluded from the sale herein provided for, and the cash or promissory notes of BUYER payable as provided in Article 7(a)(3) hereof shall be reduced by $1,266,666 for each Vessel so excluded.

12. Purchase for Investment: SELLER represents, warrants and covenants that it is acquiring the shares of Common Stock of BUYER solely for investment and not with a view to the resale or further distribution thereof.

13. Force Majeure: (a) * * *

(b) In the event, after delivery of any one of the Vessels, SELLER shall be unable to deliver, or BUYER shall be unable to accept delivery of, one or more of the Vessels due to restraints of governments, principalities, nations or the United Nations, or other reasons that may be brought about by causes beyond the reasonable control of either party, this Agreement shall not terminate, but the purchase price of the Vessels shall be reduced by the value of the Vessel or Vessels not delivered. For the purpose of this paragraph, the SS Robin Hood and SS Robin Goodfellow shall be deemed to have a value of $1,600,000 and the other Vessels shall be deemed to have the values set opposite their respective names in Article 7(b)(5) hereof. Such reduction of purchase price shall, with respect to the non-delivery of the SS Robin Hood and/or SS Robin Goodfellow be applied to reduction of the cash amounts payable as provided in Articles 7(b) (1) and 7(b)(2) hereof and, with respect to the non-delivery of any of the other Vessels, shall be applied first in reduction of the cash or promissory notes set forth in Article 7(a)(3) hereof and then in reduction of the shares of Common Stock set forth in 7(a)(2) hereof.

On March 1, 1957, contemporaneously with the execution of the above-described contract of sale, Seas entered into a stockholders' agreement with certain principal stockholders of Mooremac under which it was agreed that the parties to the agreement would vote their stock to elect directors, two of whom were to be nominated by Seas and the remaining seven by a majority of the parties to the agreement. This agreement was to continue in effect for 5 years or until Seas ***749** ceased to own beneficially at least 100,000 shares of Mooremac's stock, whichever event first occurred.

Also on March 1, 1957, contemporaneously with the agreement of sale and the stockholders' agreement, Mooremac entered into a 'memorandum of understanding' with Seas which provided, inter alia, that Mooremac would continue to employ certain key men of Seas. Mooremac, however, was not required to employ these persons for any specific length of time. The memorandum of understanding also required that Mooremac continue to use the name 'Robin Line' for a period of 5 years on the ships purchased. It was agreed that the contract of sale and stockholders' agreement as well as the memorandum of understanding would be considered as interrelated and complementary one to another.

On March 11, 1957, both parties submitted the contract of sale to the Federal Maritime Board for approval, as required by law. On April 25, 1957, the Federal Maritime Board notified the parties of its approval. In this notice of approval some of the principal terms of the contract were recited. Among the terms so recited was the designated dollar selling price for each ship and the provision for partial payment in shares at a designated rate of $30 per share. As required by its terms, both Mooremac and Seas filed their unqualified acceptance of the Federal Maritime Board's order of approval, on April 30, 1957.

Under article 10 of the contract of sale, as quoted above, Mooremac had the right to exclude two ships, the Robin Kettering and the Robin Doncaster from the transaction. On April 11, 1957, Mooremac exercised its option to exclude both vessels from the purchase. Thereafter, Seas sold these two ships, which had been ascribed values in the contract of sale to Mooremac of $1,266,666 each, to unrelated third parties for $1,350,000 each.

On May 1, 1957, Mooremac, Seas Shipping, and the Chase Manhattan Bank entered into the escrow agreement referred to in the vessel purchase agreement and Mooremac deposited with Chase Manhattan 300,000 shares of its common stock in the name of Seas Shipping. The escrow agreement provided, inter alia, as follows:

2. Disposition of Stock.-

2.01 Subject to the provisions of Section 2.04, the Escrow Agent shall deliver to The Chase Manhattan Bank, Corporate Trust Department, Transfer Agent, and to Chemical Corn Exchange Bank, Registrar, for countersignature and registration, respectively, and thereafter to the Seller, or upon its written order, in payment on account of the purchase price of the following Vessels to be purchased***750** by Buyer, the number of shares of Stock set opposite their respective names:

Name of vessel	*Number of shares*
SS *Robin Wentley*	28,667
Robin Locksley	42,223
Robin Tuxford	42,223
Robin Sherwood	42,223
Robin Trent	51,666

Robin Mowbray	51,666
Robin Gray	20,666
Robin Kirk	20,666

2.02 In the event that the Seller shall be unable to deliver, or the Buyer shall be unable to accept delivery of, one or more of the Vessels specified in Section 2.01 hereof and the Buyer and the Seller, jointly, shall notify the Escrow Agent to that effect, then, and in any such event, the shares of Stock otherwise deliverable in payment on account of the purchase price of the Vessel or Vessels not so delivered and accepted shall, subject to the provisions of Section 2.04, be disposed of by the Escrow Agent as follows:

A. By delivery to the Seller, or upon its written order, in payment first on account of the purchase price of the SS Robin Wentley, if not then yet delivered, of 13,556 additional such shares and then on account of the purchase price of the SS Robin Kirk and/or SS Robin Gray, if either or both of said Vessels shall not then yet have been delivered, of up to 31,000 additional such shares for each such Vessel; or

B. To the extent that such shares are not applied on account of the purchase price of Vessels thereafter delivered, by delivery to the Seller, or upon its written order, in prepayment on account of the Purchase Agreement, by the Buyer to the Seller on account of the purchase price of any Vessel, such prepayment to be at the rate of $30 for each share of Stock so delivered.

2.03 The balance of any shares of Stock held by the Escrow Agent, after application thereof as provided in Sections 2.01 and 2.02, shall be delivered by the Escrow Agent to the Buyer, or upon its written order.

2.04 The Buyer and the Seller, jointly, shall notify the Escrow Agent from time to time as and when Vessels shall be delivered by the Seller and accepted by the Buyer, and, promptly upon receipt of such notice, the Escrow Agent shall deliver the shares of Stock deliverable pursuant to Section 2.01 or clause A of Section 2.02 on account of the purchase price of the Vessel specified in such notice. The Buyer and the Seller, jointly, shall instruct the Escrow Agent from time to time as to dispositions, if any, of the Stock to be made pursuant to clause B of Section 2.02 or Section 2.03, and promptly upon receipt of any such instructions, The escrow Agent shall deliver to the Seller, or the Buyer, as the case may be, or upon their respective written orders, the shares of Stock deliverable pursuant to said Sections. They Buyer and the Seller shall deliver to the Escrow Agent all documents necessary to effect delivery of any Shares deliverable hereunder.

Pursuant to the aforesaid contract of sale and the escrow agreement, the ships subject to the contract (other than the two ships excluded as mentioned above) were delivered by Seas and paid for by Mooremac as follows:

Ship	Date of delivery	Cash	Notes	Shares of stock
	1957			
SS *Robin Goodfellow*	June 5	$1,600,000		
SS *Robin Gray*	June 14		$930,000	20,666
SS *Robin Hood*	June 18	1,600,000		
SS *Robin Kirk*	July 31		930,000	20,666
SS *Robin Locksley*	June 24			42,223

SS *Robin Mowbray*	May 17			51,666
SS *Robin Sherwood*	May 27			42,223
SS *Robin Trent*	May 3			51,666
SS *Robin Tuxford*	June 25			42,223
SS *Robin Wentley*	Aug. 9	406,668		28,667
Totals		3,606,668	1,860,000	300,000

***751** Pursuant to contracts made in April of 1957, Mooremac resold the SS Robin Tuxford and the SS Robin Wentley to unrelated third parties for $1,350,000 each. These ships were sister ships and also were sister ships to the Doncaster and Kettering sold about the same time by Seas for the same price.

The 300,000 shares of stock issued to Seas under the contract of sale made Seas the largest single stockholder of Mooremac; as of the end of 1957 this amounted to approximately 13 percent of Mooremac's outstanding stock. During 1957 Mooremac's chairman of the board, Emmet J. McCormack, held 212,360 shares and this was the second largest shareholding. There were 140,000 shares held by Dollar Associates, Inc. Seas acquired its stock as an investment and at the time of trial in the instant case continued to hold the 300,000 shares received on the sale of its vessels to Mooremac.

The book value of Mooremac's stock was $39.13 as of December 31, 1956, and $39.15 as of December 31, 1957.

Mooremac stock was traded on the New York Stock Exchange at a small volume during the period from March 1, 1957, to August 9, 1957, and at an average of 387 shares per day on the 8 days on which ships were delivered to Mooremac in exchange for stock. There was only slight fluctuation in the average selling price as indicated by the following table:

	High selling	Low selling	Average	Number of
Date or period	price	price	(mean) selling	shares
			price	traded
1957				
March	23 7/8	21 5/8	22.75	12,100
May 3	23 1/2	23 1/2	23.5	300
May 17	23 7/8	23 3/4	23.8125	500
May 27	22 3/4	22 5/8	22.6875	300
June 14	22 1/4	22 1/4	22.25	100
June 24	22 1/4	22 1/8	22.1875	300
June 25	22 1/4	22 1/4	22.25	100
July 31	22 3/4	22 3/8	22.5625	1,200
Aug. 9	22 1/2	22	22.25	300

During the year 1957 a total of 166,000 shares of Mooremac stock was traded on 237 of the 252 trading days on the New York Stock Exchange. The highest price at which Mooremac stock has been traded ***752** on the New York Stock Exchange to date of trial was 25 1/4 in January and February 1957.

OTHER FACTS RELATED TO THE PURCHASE OF SHIPS FROM SEAS SHIPPING CO.

Shortly after the contract of sale was entered into, Mooremac, on April 15, 1957, made application to the New York Stock Exchange for listing of the 300,000 new shares of its common stock to be issued to Seas. In this application the following statement was made:

The vessels will be charged at cost to fixed assets. The Common Stock issuable pursuant to the Agreement will be capitalized at $30 per share, deemed to be the fair market value thereof.

The application for listing was approved and the shares were listed.

In the letter of April 11, 1957, addressed to Seas Shipping in which Mooremac exercised its option to exclude the Robin Kettering and the Robin Doncaster from the transaction the concluding sentence was as follows:

In accordance with the terms of such Purchase and Sale Agreement, the purchase price for the remaining vessels to be purchased by us is, therefore, reduced by the aggregate sum of $2,533,332 to $14,466,668.

The purchase of the 10 vessels from Seas was recorded on Mooremac's books at $14,466,668. Mooremac's 1957 annual report contained financial statements audited by Arthur Anderson & Co. One of the notes to the financial statements contains the following:

In addition, the Company acquired four C-2 type and six C-3 type cargo vessels from the Seas Shipping Company, Inc., for a total purchase price of $14,467,000. Of the amount paid $9,000,000 was represented by the issuance of 300,000 shares of the Company's common stock and the balance by cash and first preferred ship mortgages. Two of the C-2 type cargo vessels which represented aggregate cost of $2,533,000 were subsequently sold resulting in a profit of approximately $54,000 net of Federal income taxes.

Including the sale by Seas of the Doncaster and the Kettering, at least nine ships similar to those purchase by Mooremac from Seas changed hands in the open market at about the same time as the sale to Mooremac and at comparable prices. Three C-2 type vessels were purchased by the Grace Line, one for $1,350,000 and the other two for $1,335,000 each (for future delivery). Four C-3 type vessels were purchased by Mooremac from Pacific Argentina Brazil Line, Inc., an unrelated corporation, for $1,625,000 each. The names of these ships, the year built, and the date of delivery are as follows:

Original name	New name	Year	Date of
		built	delivery
			1957
Pathfinger	*Mormacsun*	1943	Feb. 14
Forester	*Mormacwave*	1944	Mar. 20
Trader	*Mormacguide*	1944	Apr. 4
Seafarer	*Mormacwind*	1944	Apr. 25

***753** The purchase price of $1,625,000 each was paid in cash and was from $25,000 to $75,000 in excess of the stated contract price for comparable vessels purchased from Seas.

The two sales which give rise to the issue presented here are the sale by petitioner of the Robin Tuxford and the Robin Wentley to wholly unrelated corporations. These sales were both made under contracts entered into on April 30, 1957, which provided for closing of the transactions when the ships were delivered to Mooremac by Seas Shipping. The Tuxford sale was consummated on June 25, 1957, the same day that Seas delivered that vessel to petitioner, and petitioner incurred deductible expenses in connection with that sale of $32,046.35. The sale of Wentley was consummated on August 9, 1957, the same day that Seas delivered that vessel to petitioner, and petitioner incurred deductible expenses in connection with that sale in the amount of $35,634.36. As indicated above, the Mooremac-Seas contract price for Wentley and Tuxford was $1,266,667 each; sale of the Tuxford was accomplished by delivery to Seas of 42,223 shares of Mooremac stock, and petitioner paid $406,668 in cash and 28,667 shares of stock for Wentley. The fair market value of the Tuxford and Wentley transferred to petitioner by Seas Shipping in exchange for cash and shares of petitioner's stock was at least $1,266,667 for each vessel.

In its income tax return for 1957, petitioner reported these sales of the two vessels as short-term capital gain as follows:

Description	Date acquired and date sold	Gross sales price	Cost or other basis	Expense of sale	Gain
Vessels:					
Robin Tuxford	Apr. 30, 1957	$1,350,000	$1,266,667	$32,046.35	$51,286.65
Robin Wentley	----do-------	1,350,000	1,266,667	35,634.36	47,698.64

Respondent, in his deficiency notice, determined that the short-term gain realized on these sales was $1,374,984.29 computed as follows:

	Robin Wentley	*Robin Tuxford*	*Total*
Selling price of vessels	$1,350,000.00	$1,350,000.00	$2,700,000.00
Less: Expense of sale	35,634.36	32,046.35	67,680.71
Net selling price	1,314,365.64	1,317,953.65	2,632,319.29
Cost basis of vessels:			
Cash	406,668.00		406,668.00
Common stock:			
28,666 19/30 shares			
at $12	344,000.00		344,000.00
42,222 7/30 shares			
at $12		506,667.00	506,667.00
Total cost basis	750,668.00	506,667.00	1,257,335.00
Gain realized	563,697.64	811,286.65	1,374,984.29

***754** No explanation for the $12 per share valuation ascribed to Mooremac's stock by the respondent is made but it apparently derives from the fact that the stock as a

$12 par.

FINDINGS OF ULTIMATE FACT

The stock transferred by Mooremac to Seas as part of the purchase price of

THESE SHIPS HAD A FAIR MARKET VALUE OF $30 PER SHARE. FACTS RELATING TO BASIS OF SHIPS PURCHASED IN 1941 FROM THE U.S. MARITIME COMMISSION

In the year 1941 petitioner entered into purchase contracts with the U.S. Maritime Commission for the purchase of six vessels then owned by the United States. The total purchase price of the six vessels was $8,284,330.24.[FN1]

Upon delivery of certain of the vessels to the petitioner, they were chartered by the Government, for which the Government paid charter hire. On its Federal income tax returns for the years in which the charter hire was paid, petitioner reported the charter hire as income and deducted depreciation for the vessels.

On March 8, 1946, Congress enacted the Merchant Ship Sales Act of 1946, 60 Stat. 41, as amended, 50 U.S.C.App.sec. 1735 et seq. (1958 ed.), hereinafter sometimes referred to as the Act, which gave American citizens the right to purchase war-built ships from the United States at statutory sales prices which were substantially below the prices at which such vessels were sold by the Commission during the war. Section 9 of the Act, 50 U.S.C.App.sec. 1742 (1958 ed.), provided the opportunity, upon application, for those, like petitioner, who had bought ships during the war years to obtain a downward adjustment in their sales price 'by treating the vessel as if it were being sold to the applicant on the date of the enactment of this Act (Mar. 8, 1946), and not before that time.' The details of a section 9 adjustment are complex. They consist, however, essentially of two parts: (1) An adjustment in the purchase price down to the new statutory price (sec. 9(b)(1)-(4)); and (2) an unwinding of the transactions, including tax payments, that occurred as a result of the sale prior to 1946 (sec. 9 (b)(5)-(8)).

Petitioner filed application under section 9 of the Act for an adjustment with respect to certain vessels purchased in 1941, including the following:

Name	*Date of delivery*
Mormacreed	Feb. 9,1943
Mormaclark	Feb. 4,1943
Mormactern	Dec.29,1942
Mormachawk	Dec.14,1942
Mormacwren	Dec.26,1942
Mormacdove	Dec.31,1942

***755** The Maritime Commission granted such an adjustment in 1952, determining that under the statute the sales price of these vessels should be $5,522,376. Petitioner therefore was credited with $2,761,954.24, the difference between the statutory sales price and the original price of $8,284,330.24.

The pre-Act transactions were then unwound pursuant to the statute, as follows: (1) The Government was credited $3,381,697.01, representing the charter hire which had been paid by the Government to petitioner for use of the vessels prior to 1946; (2) the Government was debited $916,621.87, representing interest income which petitioner could have earned on the cash invested in the vessels prior to the date of the Act had this cash not been so committed; and (3) the Government was debited $1,286,110.84, representing an overpayment by petitioner of Federal income taxes, which under the Act, were recalculated to give effect to the foregoing unwinding. The sum of the unwinding debits and credits was a net credit in favor of the Government of $1,178,964,31. This amount reduced petitioner's credit on the original sales price of $8,284,330.24 from $2,761,954.24 to $1,582,989.93.

In tabular form, the computations and credits made under the Act were as follows:

STATUTORY ADJUSTMENTS

1. Original sales price	$8,284,330.24	
2. Statutory sales price	5,522,376.00	
3. Gross sales price adjustment (sec. 9(b)(1)-(4))		$2,761,954.24
4. Credits to Government:		
5. Charter hire on vessels (sec. 9(b)(6))	3,381,697.02	
6. Debits against Government:		
7. Interest on petitioner's investment (sec. 9(b)(5))	916,621.87	
8. Overpayment by petitioner of Federal income taxes (sec. 9(b)(8))	1,286,110.84	
9. Net credit in favor of Government (line 5 minus lines 7 and 8)		1,178,964.31
10. Net 1946 sales price adjustment (line 3 minus line 9)		1,582,989.93

***756** Petitioner claimed depreciation on the ships here involved[FN2] in its 1957 income tax return on the basis that their cost after readjustment was $6,701.340.31. The respondent allowed depreciation on the basis of the statutory sales price (as determined under sec. 9 of the Act) of $5,522.376. As a result thereof the depreciation deduction with respect to these vessels in the sum of $70,015.46 for the year 1957 was disallowed.

OPINION

The first issue in this case concerns petitioner's basis in the two ships SS Robin Tuxford and SS Robin Wentley which were purchased and resold in the year 1957. Under section 1011 of the Internal Revenue Code of 1954, the adjusted basis for determining gain or loss on the sale of property is the basis determined under section 1012 (as adjusted under sec. 1016 for depreciation, etc.). Section 1012 provides: 'The basis of property shall be the cost of such property.' Section 1.1012-1 of the regulations provides: In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property.' In the instant case, to determine the amount paid for the ships in dollars, it is necessary to determine the value in dollars of the shares of stocks given in payment.

In its 1957 income tax return, petitioner reported short-term gain on the sale of these two ships in the total amount of $98,985.29. This gain was computed on a cost of $1,266.667 for each ship, which was the designated value in the contract of purchase from Seas and which was based on a value of $30 per share for the stock issued in payment, plus the cash paid.

Seas Shipping Co., in reporting its gain on the 1957 sale of ships to petitioner, valued the petitioner's stock received in payment at only $19.90 per share. This valuation was also challenged by the Commissioner, who in that instance determined that the value of the stock was $39.17 per share, and Seas is contesting his action in a separate case in this Court- docket No. 3105-62. Respondent has taken a protective position between the two parties and in his briefs in the instant case, as well as in docket No. 3105-62, he restates the arguments of both Moore-McCormack and Seas Shipping and argues his own position that the value of the stock given in payment for the ships was $22.81 per share, based on trading prices on the New York Stock Exchange. Respondent's ultimate request is that whatever we determine***757** the value to be we should find the same valuation for the stock in both cases.

Since the record here indicates that the petitioner and Seas, both knowledgeable and experienced ship operating companies, were dealing at arm's length in the transaction here involved, it is entirely logical to presume that the value of the stock and cash given up by petitioner was equal to the value of the ships received. Philadelphia Park Amusement Co. v. United States, 126 F.Supp. 184 (Ct. Cl. 1954). Therefore, even though there is available in this case direct evidence of prices at which the previously outstanding shares of petitioner were traded in small volume on the stock exchange, which evidence might permit a determination of the value of the shares issued in payment for the ships without any reference to the values of the ships received, obviously, evidence of the value of the ships received is of great importance in determining the value of the stock exchanged. Amerex Holding Corporation, 37 B.T.A. 1169 (1938), affirmed per curiam 117 F.2d 1009 (C.A. 2, 1941), certiorari denied 314 U.S. 620; Rev. Rul. 55-443, 1955-2 C.B. 562, 565.

In Amerex Holding Corporation, supra at 1190, we observed:

If therefore it appears from the record that the value of the property received, upon the issuance by a corporation of certain of its shares of stock, is the best evidence of the fair market value of those shares at the time of issue, that evidence should be applied and the fair market value of the shares of stock issued determined accordingly, even though at the time of issuance the corporation already owned substantial property of value and had other shares of stock outstanding.

In the written contract of sale each of the ships is assigned a dollar value. We are certainly well aware and mindful that the agreement of the parties fixing or allocating value of assets to be sold or exchanged is not controlling as a determination by which we are bound in determining the tax consequences. Meister v. Commissioner, 302 F.2d 54 (C.A. 2, 1962), affirming a Memorandum Opinion of this Court. There is nothing in the record here, however, to indicate that the values so assigned for purposes of the contract were other than the actual fair market values of the ships recognized as such by the parties. In fact, there is an abundance of evidence which makes it apparent that the ships were in fact worth the amounts specified in the contract, if not more.

One of petitioner's witnesses was a shipbroker of considerable experience who had acted as broker in the sale by Seas of the Robin Doncaster and the Robin Kettering to third parties after petitioner had exercised its option to exclude those two ships from its contract of purchase, and also in the sale of the sister ships Robin Tuxford and Robin Wentley to third parties in 1957. This broker, who was thoroughly familiar with the ships sold by Seas to petitioner, testified that ***758** at the time of the sales of the Tuxford and the Wentley to petitioner, these ships were worth not less than $1,266,667 specified for each of them in the contract.

The correctness of the value specified in the contract is further supported by the fact that several other vessels of comparable types to those sold to petitioner changed hands in the open market, at approximately the same time as the sales to petitioner, at prices which were very closely comparable to the values placed on the Robin Line ships in the contract of sale to petitioner. In fact, the two ships were omitted at petitioner's option form the contract were sold very shortly thereafter by Seas to third parties at prices in excess of the values assigned to them in the contract with petitioner, and the two ships, the bases of which are in dispute in this case (the Tuxford and the Wentley) were resold by petitioner on the same day they were received, for prices in excess of the values assigned in the purchase contract.

Finally, strong evidence that the parties regarded values assigned in the contract as the true fair market value of the ships is found in the provisions of articles 10 and 13 of the contract itself. These articles provide for possible elimination of ships from the group being sold, under certain circumstances. If such an elimination occurs the assigned value of the ship eliminated is applied to reduce the cash and notes to be paid under the contract. Thus, if a ship assigned a value $1,266,667 is not delivered, and is eliminated from the transaction, the cash and promissory notes to be received by Seas from the entire contract is reduced by $1,266,667 as the true value of the eliminated ship. This is exactly what transpired when Mooremac exercised its option under section 10 and notified Seas at the same time that accordingly the purchase price for the remaining vessels 'is, therefore, reduced by the aggregate sum of $2,533,332 to $14,466,668.' The reduction thus effected was all in the cash and notes so that the total paid by Mooremac by cash and notes was only $2,666,668 instead of$4,800,000 specified by the contract. Since all of the ships were subject to possible elimination from the contract under article 13 (the 'Force Majeure' clause) with a resulting diminution of the cash and notes to their entire extend, the values specified in the contract indicate the true fair values of the ships.

We hold that the ships purchased by petitioner from Seas were worth no less at the time of purchase than the values assigned to those ships in the contract of sale executed by petitioner and Seas. Though of basic importance, the value of the ships received is not conclusive evidence of the value of the stock issued in exchange therefor in a situation where the market price of previously outstanding stock of the issuer trading on a stock exchange is available as direct evidence of the value of the stock itself. Pierce Oil Corporation, 32 B.T.A. 403 (1935); Rev. Rul. 56-100, 1956-1 C.B. 624.

***759** Petitioner's stock is traded on the New York Stock Exchange. Stock market quotations have been held to be the best evidence of value of a traded stock in a great number of cases. See e.g., W. T. Grant Co. v. Duggan, 94 F.2d 859 (C.A. 2, 1938); Hazeltine Corporation v. Commissioner, 89 F.2d 513 (C.A. 3, 1937), affirming 32 B.T.A. 4 (1935); Union National Bank of Pittsburgh v. Driscoll, 32 F.Supp. 661 (W.D.Pa. 1940).

The weighted average price at which petitioner's stock traded on the New York Stock Exchange on the dates of delivery of each of the ships purchased was $22.81. It is respondent's contention that $22.81 is the appropriate per share valuation of the stock issued by petitioner to Seas in exchange for the ships purchased. While we are quick to recognize the persuasive importance of stock exchange prices in a stock valuation case such as the instant one, nonetheless, we are convinced that we must carefully consider all of the evidence in the record which indicates the true fair market value for the 300,000 shares here involved. See Heiner v. Crosby, 24 F.2d 191 (C.A. 3, 1928), in which the court stated, at page 193:

Sales made at a particular time and place may be significant, but the price paid is not necessarily decisive of fair market price or value. The fact of sales, in itself and without regard to the circumstances under which the sales were made, does not conclusively establish either statutory fair market price or value. Sales made under peculiar and unusual circumstances, such as sales of small lots, forced sales, and sales in a restricted market, may neither signify a fair market price or value, nor serve as the basis on which to determine the amount of gain derived from the sale.

Similarly, sales in 100-share lots under ordinary circumstances on a stock exchange may not serve as a reliable yardstick or measure of value in the very extraordinary circumstance of the issuance of 300,000 shares representing over 13 percent of the outstanding stock of a corporation and almost twice as many shares as were traded in the entire year of issuance. See Maytag v. Commissioner, 187 F.2d 962 (C.A. 10, 1951) , affirming a Memorandum Opinion of this Court; accord, Safe Deposit & Trust Co. of Baltimore, 35 B.T.A. 259 (1937), affd. 95 F.2d 806, 812 (C.A. 4, 1938); James Couzens, 11 B.T.A. 1040, 1161 (1928).

Of paramount importance in our rejection of the mean stock market trading price as determinative of value here is the fact that what we are called upon to value is not a few hundred or even a few thousand isolated shares which can be easily valued by a determination of how much cash they could be readily converted into in the established market. Rather, we must value a lump, a block, an integrated package or bundle of rights representing ownership of 13 percent of a large and successful corporation. We must think not in terms of 300,000 individual shares of stock at so many dollars per share, but in terms of the overall dollar value of ownership of 13 percent of Moore-McCormack***760** Lines, Inc., with the shares of stock meaningful not as something which can be converted to cash but merely as the formal evidence of ownership of the 13 percent. Cf. Heiner v. Crosby, supra; accord, Perlman v. Feldmann, 219 F.2d 173 (C.A. 2, 1955), certiorari denied 349 U.S. 952 (1955).

The shares which were received by Seas were received with certain additional rights and privileges which did not attach to the shares which changed hands on the stock exchange. The 300,000-share block received by Seas carried with it a promise by petitioner to continue to operate the Robin Line and to employ certain of Seas' key men 'in positions carrying responsibility and compensation comparable to that which they have enjoyed * * * in the employ of (Seas).' It also carried the guarantee of petitioner's controlling shareholders that the 300,000 shares in the hands of Seas would control two seats on the board of directors for at least 5 years. These rights had some value above and beyond the value of the stock alone, as reflected in stock exchange prices, absent such collateral rights, and, hence, the mean stock exchange price is not determinative of the overall value of the 300,000 shares coupled with the bundle of collateral rights involved in this case. In the circumstances it is not unreasonable that the size of the block involved plus the collateral rights received in the transaction resulted in a per share value over $7 in excess of the weighted average stock exchange price of $22.81.

We note further that the volume of trading in Mooremac stock on the New York Stock Exchange at the time in question was very light. In May 9,000 shares were traded; in June 5,800 shares; in July 15,500 shares; and in August 11,100 shares. Only 166,000 shares changed hands in all of 1957. This lightness in the volume of the trading which was at an average price of $22.81 per share somewhat dilutes the persuasiveness of that average per share price as reliable evidence of the value of a block of 300,000 shares.

When a block of stock as large as 13 percent is purchased the net asset value (or book value) of the stock becomes an important consideration. The book value of petitioner's stock at the time of purchase of the ships was in excess of $39 per share. This fact further supports petitioner's contention that the $22.81 mean stock market price is too low to be regarded as the per share value of the 300,000 shares here involved. Each of the 300,000 shares issued to Seas was backed by net assets worth more than $39.

To hold that the stock issued to Seas was worth only $22.81 per share would produce an anomalous situation. The purchase price specified in the contract of $1,266,667 for the Tuxford was paid by the issuance of 42,223 shares of stock, and the same purchase price for the Wentley was paid by the issuance of 28,667 shares of stock plus $406,668 in cash. If the stock were valued, as the respondent suggests, ***761** at only $22.81 per share instead of $30, as petitioner valued it, the cost of the Tuxford would by $963,106 while the cost of the Wentley would be $1,060,562. This disparity is unrealistic in view of the fact that the two ships were sister ships of the same type, built at the same time, were assigned equal values in the contract of sale to petitioner, and were sold immediately upon delivery for equal amounts by petitioner.

Finally, the evidence is plentiful that both parties in their dealings with third parties and stockholders gave every indication that they regarded the stock as worth $30 per share. Both parties submitted the contract for approval to the Federal Maritime Board and accepted the Board's approval which contained a recitation of the provisions that shares of petitioner were to be accepted in payment at a rate of $30 per share.

The Board's approval, accepted unconditionally by both petitioner and Seas Shipping, authorized Seas to sell and Mooremac to purchase the 10 vessels 'to be paid for by Moore-Mac' as follows:

1. SSs *Robin Goodfellow* and *Robin Hood* in cash to be withdrawn from Moore-Mac's capital reserve fund		$3,200,000
2. SSs *Robin Tuxford* and *Robin Locksley* at $1,266,667 each:		
Mortgage to Seas	$2,266,669	
8888.8 shares common stock at $30 per share	266,665	
		2,533,334
3. The following vessels with 291,111.2 shares of common stock to be issued to Seas at $30 per share:		
SS *Robin Sherwood*	1,266,667	
SS *Robin Wentley*	1,266,668	
SS *Robin Gray*	1,550,000	
SS *Robin Kirk*	1,550,000	
SS *Robin Mowbray*	1,550,000	
SS *Robin Trent*	1,550,000	
		8,733,335
Total		14,460,669

That both petitioner and Seas Shipping recognized that the total contract price for the 10 vessels was $14,466,668(9) is apparent from their unqualified acceptance of all of the provisions contained in the Maritime Baord's authorizing letter of approval of the sale dated April 25, 1957. The total approved price to be paid by petitioner to Seas was $14,466,669. A sale of the vessels at that price was the only sale ever authorized by the Federal Maritime Board under the 1916 Shipping Act.

Petitioner represented to the New York Stock Exchange in an application for listing of the shares to be issued to Seas, apparently without objection by Seas, that the fair market value of the shares to be issued was $30 per share. In its annual report to shareholders for 1957, ***762** audited by a nationally known firm of accountants, the purchase of the ships from Seas was reflected in such a way on both the assets and the stockholders' equity sections of the balance sheet as to indicate that the stock issued pursuant thereto was issued at a value of $30 per share. In a note to its 1957 financial statements petitioner represented to its shareholders that the aggregate purchase price of the 10 ships was $14,467,000, a figure which assumes a value of $30 per share for the stock issued. In the letter from petitioner to Seas in which petitioner exercised its option to exclude the Doncaster and the Kettering from the contract petitioner referred to the remaining aggregate price for all the ships in terms only of dollars- not in terms of dollars and shares- with shares apparently converted to dollars at a rate of $30 per share. Hence, it appears abundantly clear that, both in the contract itself and thereafter in dealings with third parties and with each other, both of the parties to the contract at all times regarded the 300,000 shares of stock as worth $30 per share.

In finding as an ultimate fact that the 300,000 shares of petitioner's stock issued to Seas in 1957 in exchange for ships of the Robin Line were worth $30 per share, we have carefully examined and weighed all of the evidence submitted by both parties. We have done our best to give to each bit of evidence the weight to which it is entitled in using our best judgment to find fair market value. Based upon all of the evidence before us thus considered and applying our reasoned finding of fair market value to the issue before us, we hold that the cost basis to petitioner of the SS Robin Tuxford was $1,266,690, and the cost basis to petitioner of the SS Robin Wentley was $1,266,678.[FN3]

The second issue in this case involves the question of the proper cost basis upon which petitioner is entitled to compute a depreciation deduction for certain ships acquired under a 1941 contract in a transaction subject to the Merchant Ship Sales Act of 1946. In its Federal income tax return for the year 1957 petitioner took depreciation on these vessels on the assumption that their cost basis was not the statutory sales price, $5,522,376, but rather $6,701.340.31, the difference between $8,284,330.24, the original sales price, and $1,582,989.93, the net 1946 sales price adjustment credited to petitioner.

Petitioner's argument, quite simply, is that during the war it paid $8,284,330.24 for the ships. Pursuant to the adjustment under the 1946 Act, petitioner asserts it was paid back $1,582,989.93. Thus, petitioner concludes that its cost and therefore its depreciation basis for tax purposes in these ships is the difference between these two figures or $6,701,340.31. The respondent agrees that petitioner paid $8,284,330.24 during the war and received back $1,582,989.93 under the ***763** Act. Respondent points out, however, that if the net credit to the Government under the unwinding provisions of the Act ($1,178,964.31), which represents the net refund to the Government for charter hire paid during the war, were to be added to the statutory sales price in order to compute tax basis, this would defeat an essential purpose of the Act to put all wartime purchasers on the same footing as post-Act purchasers. Thus, the basis for post-Act purchasers would be the statutory sales price; the basis to Pre-act purchasers would be the statutory sales price plus the net credit to the Government for refund of charter hire. Pre-Act purchasers would have the advantage of higher bases and consequent larger depreciation deductions. Respondent also argues that the unwinding adjustments under the Act are not capital items; they are explicit earnings adjustments, and that such earnings adjustments cannot enter into the computation of basis for depreciation.

This issue, involving certain income tax effects of section 9 of the Merchant Ship Sales Act, is not a novel one. Several courts have tackled the problem here presented, with an unfortunate lack of unanimity in their results. At least two District Courts and the Court of Claims have held for the taxpayer: Waterman Steamship Corporation v. United States, 203 F.Supp.915 (D. Ala. 1962), rev. 330 F.2d 128 (C.A. 5, 1964); Socony Mobil Oil Co. v. United States, 287 F.Supp. 451 (D. N.J. 1955). At least two circuit courts and one District Court have held for the Government: National Bulk Carriers, Inc. v. United States, 194 F.Supp. 585 (D. Del. 1963), affd. 331 F.2d 407 (C.A. 3, 1964); Waterman Steamship Corporation v. United States, 330 F.2d 128 (C.A. 5, 1964), reversing 203 F.Supp. 915 (D. Alam 1962).

It was not without some relief that this Court learned that the tempest in the courts surrounding the Merchant Ship Sales Act of 1946 which has caused choppy seas for the ships of many taxpayers subsided just as it began to pound our own shores in the instant case. The conflict in the above-cited cases was resolved on May 17, 1956, subsequent to the trial and filing of briefs in the instant case when the Supreme Court handed down its decision in Waterman Steamship Corporation v. United States, 381 U.S. 252 (1965), affirming 330 F.2d 128 (C.A. 5, 1964).

The second issue in the instant case is identical to the issue presented to the Supreme Court in Waterman, and, therefore, we deem that case to be controlling on our decision here. The Supreme Court held that the proper basis for depreciation on ships subject to section 9 of the Merchant Ship Sales Act of 1946, is the statutory sales price under the Act. Nothing further would be accomplished by our discussing the arguments of the parties in the instant case or the reasons why the Supreme Court reached the result it did in Waterman. Justice Goldberg's***764** very clear exposition of the arguments on both sides and his thorough examination of the statutory history of the Merchant Ship Sales Act of 1946 require no further elaboration from us.

We hold, accordingly, that the basis of the six vessels purchased in 1941 whose prices were readjusted pursuant to section 9 of the Merchant Ship Sales Act of 1946 is their statutory sales price of $5,522,376. Waterman Steamship Corporation v. United States, supra.

Decision will be entered under Rule 50.

FN1. The total purchase price consisted of a cash payment and a mortgage indebtedness. For simplicity in this opinion, the $8,284,330.24 purchase price will be considered as if it had all been paid in cash. See Waterman Steamship Corporation v United States, 381 U.S. 252 fn.1 (1965).

FN2. Actually three of the above-described ships purchased in 1941 were exchanged pursuant to sec. 8(d) of the Merchant Ship Sales Act prior to the tax year here in question, for three other vessels of a like kind which were similarly held for productive use in the business of petitioner. However, the adjusted basis of each old vessel carried over to the vessel received therefor and petitioner continued to deduct depreciation on the new vessel on such adjusted basis. Hence, this exchange has no effect on the legal issues here involved.

FN3. The slight dollar discrepancy is not explained by the record which as our findings indicate showed payment of 42,223 shares of stock for Tuxford and 28,667 shares of stock plus $406,668 in cash for Wentley.

Tax Court 1965.
Moore-McCormack Lines, Inc. v. C. I. R.
44 T.C. 745

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United States Court of Appeals,
Seventh Circuit.
KOHLER COMPANY, Plaintiff-Appellee,
v.
UNITED STATES of America, Defendant-Appellant.
No. 05-4472.

Argued Sept. 27, 2006.
Decided Nov. 20, 2006.
Rehearing and Rehearing En Banc Denied Feb. 12, 2007.

Background: Corporate taxpayer sought refund of taxes paid following audit of its transactions in Mexican debt obligations, on which it was determined taxpayer had realized short-term capital gain. Following denial by United States District Court for the Eastern District of Wisconsin of taxpayer's initial motion for summary judgment, 247 F.Supp.2d 1083,William C. Griesbach, J., District Court granted taxpayer's second summary judgment motion, 387 F.Supp.2d 921. Government appealed.

Holding: The Court of Appeals, Posner, Circuit Judge, held that IRS's assessment of capital gain for entire difference between taxpayer's basis in debt it sold to Mexico, and pesos received in return, was excessive, obligating IRS to produce supporting evidence.
Affirmed.

West Headnotes

Internal Revenue 220 ⚷5076

220 Internal Revenue
220XXVIII Refunding Taxes
220XXVIII(B) Actions for Refunds
220XXVIII(B)8 Evidence
220k5075 Presumptions and Burden of Proof
220k5076 k. In general. Most Cited Cases

In corporate taxpayer's refund action arising from its sale to Mexico of Mexican debt, purchased at discount for $11.1 million, in exchange for $19.5 million in pesos, Internal Revenue Service's (IRS) determination that entire $8.4 million difference constituted taxable capital gain was clearly excessive, given restrictions on pesos including fact that they had to be spent in Mexico on specific capital project; thus, even though taxpayer had general burden of persuasion, and some gain had been realized, IRS was obligated first to produce some evidence in defense of its assessment. 26 U.S.C.A. § 1001(c); 26 C.F.R. § 1.1001-1.

***1032** Janice A. Rhodes, Kravit, Hovel, Krawczyk & Leverson, Milwaukee, WI, Philip Karter (argued), Herbert Odell, Miller & Chevalier, West Conshohocken, PA, for Plaintiff-Appellee.

Bruce R. Ellisen, Bridget M. Rowan (argued), Dept. of Justice, Tax Division, Appellate Section, Washington, DC, for Defendant-Appellant.

Before POSNER, MANION, and WILLIAMS, Circuit Judges.

POSNER, Circuit Judge.

Kohler, the well-known manufacturer of plumbing products, brought suit for a refund of federal income taxes. It won on summary judgment, 387 F.Supp.2d 921 (E.D.Wis.2005), and the government appeals.

In 1986, Kohler decided to build a plant in Mexico that it estimated would cost at least $29 million. It needed pesos in order to pay for land, building contractors, and other inputs. How to get them?

Now it happened that Mexico had defaulted on its foreign debt, and in an effort to restore its credit had adopted an ingenious "debt-equity swap" program pioneered by Chile. The program entitled a foreign company that wanted to invest in ***1033** Mexico, and therefore needed pesos, to purchase defaulted Mexican dollar-denominated debt on the open market and then swap it with the Mexican government for pesos that could be spent only in Mexico rather than exchanged for dollars. International Business Corporation, *Debt-Equity Swaps: How to Tap an Emerging Market* 1 (1987). The program enabled the Mexican government to retire some of its foreign-owned debt without having to pay "hard" money-that is, foreign currency, or, what would amount to the same thing, pesos convertible to foreign currency.

Bankers Trust, the American bank, owned Mexican debt in the face amount of $22.4 million. This debt traded at a substantial discount because of Mexico's default, fiscal instability, and general lack of creditworthiness. As a result, Kohler was able to buy the debt from Bankers Trust for only $11.1 million, slightly less than half its par (face) value. The bank preferred the bird in the hand (11.1 million U.S. dollars) to two birds, consisting of claims against the Mexican government, very deep in the bush.

Kohler knew that under the terms of the debt-equity swap program the Mexican government would swap the $11.1 million debt that Kohler had bought from Bankers Trust for $19.5 million worth of pesos as calculated at the then current market exchange rate of 2245 pesos to the dollar. The qualification in "as calculated at the then current market exchange rate" is critical. If for one reason or another that was not the right exchange rate to use for this transaction, the pesos that Kohler received may not really have been worth $19.5 million. That they were worth less is shown by Mexico's willingness to offer $19.5 million in pesos for debt that Kohler had purchased for only $11.1 million. Mexico had to compensate Kohler for accepting pesos that came with restrictions that reduced their dollar value. The pesos had to be spent in Mexico on projects approved by the government and could not be freely converted to dollars or other foreign currencies until 1998. So although the market exchange rate was, as we said, 2245 pesos to the dollar, Kohler received a rate of 3939 pesos to the dollar, which is what turned $11.1 million of dollar debt into $19.5 million in pesos. Kohler did however use all the pesos to pay for real estate and other costs that it incurred in building its plant.

On its federal income tax return it treated the purchase of the debt and its sale to the Mexican government as a wash, yielding no taxable income, just as if the government had paid it $11.1 million in dollars rather than paying it in pesos. The Internal Revenue Service disagreed with this treatment and instead added to Kohler's taxable income for 1987, the year of the transaction, the difference of $8.4 million between the price that Kohler had paid Bankers Trust for the Mexican debt and $19.5 million.

One might have thought that the way to account for Kohler's purchase of Mexican debt would have been to add $11.1 million to the basis of Kohler's investment in the Mexican plant, so that if it ever sold the plant the difference between on the one hand the sale price and on the other hand the sum of $11.1 million and all the other costs of the plant would be the taxable income attributable to the sale. Then if the Mexican government's purchase of $11.1 million in debt from Kohler for $19.5 million in pesos was a windfall for Kohler, reducing the real cost of the plant, Kohler would realize a greater profit from the eventual sale of the plant than it would have realized otherwise, and that profit would be taxable. Even if the plant was never sold, the windfall would give Kohler higher profits (presumably taxable) on sales of the plant's output because the ***1034** deductions from taxable income that it could take for depreciation of the cost of the plant would be lessened by the $8.4 million reduction in its basis.

An alternative way of accounting for the swap would have been to accept Kohler's argument that the value of the debt that it purchased was unascertainable at the time of purchase and treat the exchange of the debt for the peso account as a swap yielding no taxable income. Any capital gains that resulted in the future from Kohler's use of the pesos to purchase goods and services for its project would be taxable. So if it used the entire amount to buy real estate and construction services before any change in the exchange rate, it would be deemed to have realized a capital gain of $8.4 million ($19.5 million minus $11.1 million) on the purchase.

Still another alternative would be to deem the difference between the two amounts a contribution of capital to Kohler's enterprise by the Mexican government. Such a contribution would not be included in Kohler's gross income, 26 U.S.C. § 118(a), though it would be recorded on Kohler's books as having a zero basis, 26 U.S.C. § 362(c), and so could not be depreciated. Although this approach was adopted in the nearly identical case of *G.M. Trading Corp. v. Commissioner of Internal Revenue,* 121 F.3d 977 (5th Cir.1997), we are dubious about it. Compensation for a "specific, quantifiable service" cannot be classified as a contribution to capital, *United States v. Chicago, Burlington & Quincy R.R.,* 412 U.S. 401, 413, 93 S.Ct. 2169, 37 L.Ed.2d 30 (1973)-and the Mexican government, to the extent it "overpaid" Kohler for the bonds, was buying a service from Kohler: retirement of a part of Mexico's foreign debt. See Scott A. Shane, "A U.S. Policy Toward Debt-Equity Swaps," 16 *J. Soc., Pol. & Econ. Stud.* 287 (1991); Morris B. Goldman, "Debt/Equity Conversion; A Strategy for Easing Third World Debt," *Heritage Foundation Reports* 1 (Jan. 21, 1987).

The court in *G.M. Trading* thought the purpose of the Mexican debt-equity swap program was to encourage foreign investment in Mexico. That was *a* purpose, but it was secondary to Mexico's desire to retire its foreign debt-the service for which it paid Kohler by exchanging dollar debt for pesos. In deciding at what rate to exchange foreign debt for pesos, moreover, Mexico ranked projects according to their investment value, and Kohler's type of project was rated below several others, such as projects designed to privatize state industries. International Business Corporation, *supra,* at 56-57; Morgan Guarantee Trust Company, "Debt Equity Swaps," *World Finance Markets* 14 (June-July 1987). The debt held by companies that planned to use their pesos for the investments most favored by the government was redeemed in pesos at par. Remember that the par (face) value of the debt that Kohler bought from Bankers Trust was $22.4 million, or 50.4 billion pesos at the market exchange rate of 2245 pesos per dollar. Kohler was offered only 87 percent of this amount (43.8 billion pesos). Mexico would not have gone out of its way to encourage Kohler's project had it not been for the opportunity to retire some of its foreign debt. In fact it was Kohler-whose decision to build the plant predated the swap program-that approached the Mexican government about initiating a swap, rather than vice versa.

No doubt the government's motives were mixed, as indicated by the fact that some companies that tendered dollar debt for redemption in pesos were given the less attractive exchange rate of 3399 to the dollar, compared to Kohler's 3939; their projects were not the kind of foreign investment that the government especially wished to attract. Kohler's project was ***1035** what is called a "maquiladora," a project whereby (in the usual case) a plant imports raw materials into Mexico for processing into finished products that are exported. Thus, as a further condition of the swap, Kohler promised to export at least 20 percent of the output of its plant, which would earn dollars for Mexico, which wanted to encourage foreign investment that would build its dollar holdings. That condition doubtless induced the favorable exchange rate that Kohler received, and maybe the difference between that rate and the bottom rate of 3399 pesos per dollar, translated into dollars, could be considered a contribution to capital by Mexico.

There is no need to pursue the issue. The parties have taken none of the paths we've laid out. (The second-the wait-and-see approach-strikes us as the most practical, as it involves no conjecture.) They treat the sale of the Mexican debt for the peso account as just that-a taxable sale-consistent with the rule that an exchange of "materially different" things (the Mexican dollar debt for the pesos) is an event in which profit or loss is realized. 26 U.S.C. § 1001(c); 26 C.F.R. § 1.1001-1. *Cottage Savings Ass'n v. Commissioner of Internal Revenue,* 499 U.S. 554, 556, 111 S.Ct. 1503, 113 L.Ed.2d 589 (1991), is illustrative: "a financial institution realizes tax-deductible losses when it exchanges its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans."

The parties quarrel only over the value to Kohler of the exchange when made. The quarrel has driven them to take opposite positions, both untenable. Kohler argues that it had no gain from the sale at all, while the Internal Revenue Service argues that the entire difference between the $19.5 million in pesos that the Mexican government gave Kohler and the $11.1 million that Kohler had paid to buy the debt that it swapped for the pesos was taxable income to Kohler. Kohler's position is untenable because $11.1 million in Mexican foreign debt was worth more to it than to Bankers Trust. It wanted pesos; Bankers Trust did not. Kohler argues absurdly that if it gained from the purchase, the bank must have lost, and why would it sell at a loss? Most transactions produce a gain to both parties-that is what induces the transaction.

Yet the pesos were not worth the full $19.5 million at which the Mexican government valued them for purposes of the exchange, because they were not convertible into dollars or any other currency. They could be used only in Mexico and in fact only to build the intended plant. Had Kohler decided not to build the plant, because of changed conditions after its purchase of the debt from Bankers Trust, it would have been battered by the severe inflation that afflicted Mexico throughout the 1980s. That is why we suggested earlier that the dispatch with which Kohler spent its pesos would determine the actual value of the exchange to it (the "wait-and-see" approach). A dollar restricted to being used to purchase the currency of a country in the throes of a financial crisis is worth less than a dollar.

How to choose between adversaries' valuations when both are manifestly erroneous? The conventional response would be that the party with the burden of proof (in the sense of the burden of persuasion) would lose. And that is Kohler-and would be, by the way, even if it had not paid the additional tax assessed by the IRS but instead had challenged the deficiency in the Tax Court. Tax Ct. R. 142(a); *Kikalos v. Commissioner of Internal Revenue,* 434 F.3d 977, 982 (7th Cir.2006); Leo P. Martinez, " ***1036**Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases," 39 *Hastings L.J.* 239, 257-60 (1988).

But Kohler argues that it needs no evidence, citing *United States v. Davis,* 370 U.S. 65, 82 S.Ct. 1190, 8 L.Ed.2d 335 (1962), a superficially similar case won by the taxpayer. Pursuant to a divorce settlement, Davis agreed to transfer stock to his wife in exchange for her surrender of her marital property rights. In effect he bought those rights for the value of his stock, just as Kohler in effect bought pesos from the Mexican government for $11.1 million, since the money it paid Bankers Trust was the only outlay it made to get the pesos. The Court in *Davis* held that the only taxable gain on the transaction was the difference between the market value of the stock and the taxpayer's basis-not the difference between the value of the wife's marital rights, corresponding to the pesos that Kohler acquired in this case, and the taxpayer's basis. The Court reasoned that "absent a readily ascertainable value" of the acquired property, it should be assumed to be equal in value to what the taxpayer had paid for it. *Id.* at 72, 82 S.Ct. 1190. Otherwise, as the Court explained, the wife would not know, if she should later sell the stock, what her basis was-that is, what she had paid in exchange for the stock by giving up her marital rights. *Id.* at 73, 82 S.Ct. 1190.

But the Court merely assumed, it did not hold, that the wife's marital rights could not be ascertained with sufficient precision to enable a calculation of the taxpayer's "real" gain (or loss). The Court of Claims had held that because in its view the value of those rights could not reasonably be ascertained, their exchange for the taxpayer's stock was not a taxable event. The Supreme Court, assuming-but not ruling on-the soundness of the Court of Claims' finding on ascertainability, held that the exchange was still a taxable event, only one in which the only gain realized was the difference between the market value of the stock (it was publicly traded-it was DuPont stock) and the taxpayer's basis in the stock. *Id.* at 71-73, 82 S.Ct. 1190. In other words, if property received in an exchange cannot be valued, the taxable gain is limited to the difference between the sale price and the seller's basis.

The problem in our case is different. It is what to do when the value of the property exchanged may well be ascertainable but has not been ascertained. To permit the Internal Revenue Service to place an arbitrary value on difficult-to-value property obtained in a transaction and require the taxpayer to prove that it was worth less-and exactly how much less-would place an unreasonable burden on taxpayers. Suppose a lawyer and a dentist bartered legal services for dental services and the IRS assessed the legal services as worth only $10,000 and the dental services as worth $1 million and so assessed $990,000 in additional taxable income to the lawyer. The government would have to present *some* evidence in defense of its extravagant assessment before the burden of production and persuasion would shift to the taxpayer. This conclusion is implicit in cases that hold that when the IRS makes a "naked" assessment, which is to say one "without any foundation whatsoever," the taxpayer does not have to prove what the assessment should have been. *United States v. Janis,* 428 U.S. 433, 440, 96 S.Ct. 3021, 49 L.Ed.2d 1046 (1976); see also *Helvering v. Taylor,* 293 U.S. 507, 55 S.Ct. 287, 79 L.Ed. 623 (1935).

So here, the government's assessment was undeniably excessive because it took no account of the restrictions that the seller of the pesos (the Mexican government) had placed on the purchase. Among the restrictions is one that we haven't mentioned yet: Kohler was forbidden to trade its pesos with Mexicans for dollars (Mexico ***1037** didn't want dollars going out of the country), so that if it had decided against building the Mexican plant and had no other use for pesos it would have had to exchange them for dollars with other foreign companies planning similar or (as judged by Mexico) inferior projects. If, for example, a company was contemplating a project that the Mexican government thought so desirable that it would redeem the company's Mexican debt at par ($22.4 million in pesos versus the $19.5 million in pesos that Kohler received), the company could deal directly with the government rather than buying Kohler's pesos. It would buy those pesos only if Kohler gave it a discount that would make the buyer as well off as if he had dealt directly with the Mexican government.

We think the Internal Revenue Service had either to prove against all probabilities that its assessment was correct or pick a number that was prima facie plausible-a number somewhere in between $11.1 million and $19.5 million. Its effort, by means of an expert witness, to prove that the pesos were indeed worth $19.5 million fell pathetically short of the mark. The expert had not attempted to calculate the discount that a purchaser of restricted pesos would have demanded. Kohler's efforts to show that the pesos it received from the Mexican government were worth the same as the debt it had exchanged were equally pathetic. Kohler was committed, though apparently not irrevocably, to a project that would cost more in pesos than the pesos it was obtaining from the Mexican government. Although the pesos obtained in the swap wouldn't be spent all at once, the government had guaranteed that until they were spent they would earn interest at a high rate and be guaranteed against any devaluation of the peso (though not against inflation). Given Mexico's parlous financial situation, the transaction was not riskless to Kohler. But Kohler would not have paid $11.1 million to obtain pesos from the Mexican government had it not thought that the government's offer to give it 75 percent *more* pesos than it could have bought on the open market for $11.1 million ($19.5-$11.1= $8.4 / $11.1 =.75) would yield it a profit.

The same thing can be worth more to one person (Kohler) than to another (Bankers Trust); that is the basis of market transactions. To a holder of Mexican debt that had no use for pesos, the debt was worth only half its face amount; to someone like Kohler who needed a great many pesos, the debt was worth more. How much more? Not $8.4 million more; and we have said that before a taxpayer can be required to disprove an extravagant evaluation the Internal Revenue Service must present some evidence to support it. The Service presented no evidence that could have persuaded a rational factfinder that the pesos Kohler got from the Mexican government in exchange for the debt it surrendered were worth $19.5 million. The Service could have justified a more modest estimate yet one well above $11.1 million, but clinging stubbornly to its untenable valuation it suggested no alternative to $19.5 million. It played all or nothing, lost all, so gets nothing.

AFFIRMED.

C.A.7 (Wis.),2006.
Kohler Co. v. U.S.
468 F.3d 1032, 98 A.F.T.R.2d 2006-7983, 2006-2 USTC P 50,611

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December 11, 2010

Mr. Jeffrey A. Niesen, CPA
Vice President, Taxes
Kingston Technology Corporation
17600 Newhope Street
Fountain Valley, CA 92708

Subject: Fair Market Value calculations pertaining to a Promissory Note between Kingston Technology Corporation and Softbank Kingston, Inc.

Dear Mr. Niesen:

Pursuant to your authorization, Mesirow Financial Consulting LLC, (referred to as "MFC"), has assisted Kingston Technology Corporation ("Kingston", "KTC" or the "Company") with updating certain assumptions and valuation calculations described in a report (the "Kroll Report") issued by Kroll, Inc. ("Kroll"), on March 25, 2003 to Stradling Yocca Carlson & Rauth ("Stradling") and pertaining to the determination of the Fair Market Value (as defined in the Kroll Report) of a promissory note between Kingston Technology Corporation and Softbank Kingston, Inc.

In preparing its analysis, Kroll performed certain procedures, as set forth in the Kroll Report, to estimate the Fair Market Value at December 31, 1998 ("Kroll's Date of Valuation") of a Contingent Promissory Note ("the Note") owned by KTC, and issued by Softbank Kingston, Inc. ("SKI"). We understand that the results of the Kroll analysis was used by Stradling, Kingston Technology Corporation, John Tu, David Sun, and Kingston management ("Management") for tax reporting purposes.

In preparing our calculations of Fair Market Value, MFC has applied a methodology identical to Kroll's analysis, but reflecting a later date of valuation, July 14, 1999 ("MFC's Date of Valuation"). MFC's Date of Valuation reflects information not known as of the Kroll's Date of Valuation and consequently reflects a much lower Fair Market Value for the Note than does the Kroll analysis.

About the Mesirow Team

As background, and as you know, I was the Managing Director at Kroll responsible for, and co-signor of, the Kroll Report. Further, I am currently employed by Mesirow Financial Consulting as a Senior Managing Director, and among other responsibilities, I am a co-leader of our national valuation practice. MFC employs approximately 100 professionals in ten cities around the U.S. and in England. MFC provides a range of consulting services including; valuation, expert testimony, bankruptcy and reorganization assistance, accounting due diligence and, others. MFC is a wholly owned subsidiary of Mesirow Financial, Inc. ("MFI"). MFI employs approximately 1,200 professionals and is a diverse financial services organization whose product offerings include the management of approximately $30 billion in third-party funds.

The Contingencies

As described in the Kroll Report, the Note contains two contingencies (the "Contingencies") that are brief summarized as follows:

- ***EBIT Contingency:*** The first "contingent" event is that KTC report (in audited financial statements), for the period January 1, 1997 through the end of the most recent fiscal year, cumulative annual average earnings before interest and taxes ("EBIT") of the Company in an amount equal to or greater than $300 million.

- ***BEV Contingency:*** The second "contingent" event is the closing of an initial public offering of securities of the Company or a sale of the Company (representing a controlling interest in the Company) at a pre-money business enterprise value ("BEV") of at least $1.8 billion.

Key Assumptions

Similar to the Kroll analysis, a Black-Sholes option model ("BSOM") has been utilized to derive the probability of achieving each contingency within each year remaining in the Term of the Note. While the BSOM is often utilized to derive the value of an option, in determining value, it also calculates the probability that the contingency within the option will be achieved (i.e. that the value of the underlying security will achieve a designated value, the "target price", within a defined time period). It is this determination of probability endogenous to the BSOM that has been utilized in Kroll's and MFC's analyses.

The probability of achieving the contingency is primarily circumscribed by these four parameters:

- **Target Value:** The target BEV and, separately, the target cumulative average annual EBIT = $300 million for the Note.

- **Volatility:** The degree to which the BEV and EBIT are expected to fluctuate over time.

- **Term:** The time period over which the Contingencies, should one occur.

- **Current Value:** The known BEV at the Valuation Date and, separately, the known cumulative average annual EBIT at the Valuation Date.

Two parameters are identical in the Kroll and MFC analyses (Target Value and Volatility). Two parameters (Term and Current Value) are changed in the MFC analysis to reflect a change in the Date of Valuation and information known as of the later valuation date.

Note Value Calculation

MFC has calculated the Note's Fair Market Value as the present value of the contingent loan payments multiplied by the estimated probability of achieving each contingency. Consideration of the values derived for each Contingency resulted in a calculated Fair Market Value for the Note. Assumptions used in the MFC calculations ("Revised Assumptions") that are different from the Kroll analysis include the following:

- **Term:** The Kroll analysis reflects a Date of Valuation of 12/31/98, exactly six years from the termination of the Contingencies. The MFC Date of Valuation is 7/14/99, approximately five and one half years from the termination of the Contingencies. Therefore, MFC has utilized a 5.5 year assumption for Term, as compared to Kroll, which utilized a 6.0 year Term assumption.

- **Current Value BEV:** Kroll derived the Fair Market Value for the KTC BEV based the discounted cash flow and market multiple approaches to value. These approaches reflected the recent historical and expected future performance of KTC as of 12/31/98. MFC identified Fair Market Value for KTC based on the arms-length price ($450 million) paid for KTC as of 7/14/99 plus the estimated value for the Note (rounded for analytical purposes to $10 million).

- **Current Value EBIT:** Kroll's analysis of the EBIT Contingency utilized an actual EBIT for 1998 of $84 million. MFC's analysis of the EBIT Contingency utilized an actual EBIT for 1999 of $76 million.

Calculation Conclusions

The Kroll analysis resulted in a BEV Contingency value of $22,400,000 and an EBIT Contingency value of $7,600,000. The concluded value of the Note in the Kroll Report was $22,400,000.

In preparing its analysis and reaching its conclusion of Fair Market Value, Kroll utilized data available at 12/31/98. The sale of KTC for $450 million was not considered in the analysis, reflecting the fact that the sale in July of 1999 was not known as of 12/31/98 (even though the sale was known as of the date the valuation analysis was prepared in March 2003). Further the fact that the actual earnings of KTC were less than the projections was not considered by Kroll.

Based on the Revised Assumptions, MFC's calculated value of the BEV Contingency is $7,600,000 and the calculated value of the EBIT Contingency is $6,400,000.

As described in the Kroll Report, the "most likely" of the two contingencies sets the value of the Note. Utilizing this same approach, the calculated Fair Market Value of the Note, as of the Revised Valuation Date is: **Seven Million Six Hundred Thousand Dollars ($7,600,000 dollars).**

These decreases in values between the Kroll and MFC analyses are as expected and reflect the fact that the probability of the Note becoming due has decreased substantially between 12/31/98 (Kroll's Date of Valuation) and 7/14/99 (MFC's Date of Valuation) as noted by the following:

- The BEV of KTC was estimated at $760 million in the Kroll Report. The Revised Assumptions BEV is $460 million. The decrease in BEV resulted in a greater required value increase in the BEV necessary to fulfill the BEV Contingency. A greater increase is less likely to occur in a limited time period.

- The EBIT reported for KTC in 1999 was $76 million (1999 actual), instead of the estimated $84 million utilized by Kroll (1998 actual). The decrease in EBIT resulted in a greater increase in EBIT necessary to fulfill the EBIT Contingency. A greater increase is less likely to occur in a limited time period.

- The time period over which the contingency can be met has decreased by approximately 6 months (from 6 years to 5.5 years) due to the fact that value was measured in the Kroll Report as of 12/31/98 and in MFC's analysis as of 7/14/99. A shorter time frame makes it more difficult and less likely that the required BEV and EBIT increases can be achieved.

Closing

We understand that the results of our analysis will be utilized by Management for tax reporting purposes. Our analysis has included updating only those specific assumptions identified herein. Certain market based assumptions (e.g. revised financial projections for Kingston, risk free rate, etc.) that are expected to have a minimal impact on the value calculation have not been updated. Further, we understand that SKI is a subsidiary of Softbank, Inc., a Japanese public company, and have assumed that a $450 million purchase price accurately reflects the amount paid for the business in an arms-length transaction.

Our analysis is to be used only with regard to the purpose stated herein. Neither our analysis nor its contents may be used for any other purposes or by other parties without the prior written authorization of MFC. Our analysis was based upon information provided by Kingston, and developed from other independent sources. We did not independently investigate or otherwise verify the data provided and do not express an opinion or other form of assurance regarding its accuracy or completeness. The terms and conditions applicable to valuation projects performed by MFC, and to which this study is subject, are included as referenced in our engagement letter dated with Kingston.

We are pleased to provide this valuation service to Kingston Technology Corporation. Should you have any questions concerning our analysis or this letter, please contact James Wilson, Senior Managing Director at (213) 614-7057. We appreciate having had this opportunity to provide consulting services to Kingston Technology Corporation and look forward to working with you again in the future.

Very truly yours,

James Wilson/dc

James Wilson
Senior Managing Director
Mesirow Financial Consulting LLC

KINGSTON TECHNOLOGY CORPORATION EXHIBIT 1

OPTION VALUE OF THE NOTE
July 14, 1999

CALCULATION OF THE FAIR MARKET VALUE OF THE NOTE: CONCLUSION

Note Value Resulting from Business Enterprise Value ("BEV") Contingency: Sale of the Business for *at least* $1.8 billion	Exhibit 2-A	$ 7,614,468		
Note Value Resulting from the Earnings before Interest and Taxes ("EBIT") Contingency; Cummulative average annual EBIT *greater than or equal to* $300M	Exhibit 2-B	OR	$ 6,398,718	
Conclusion of Value based on the more likely *Option Value* of the two Contingencies				$ 7,614,468
Conclusion of Value (Rounded)				**$ 7,600,000**

KINGSTON TECHNOLOGY CORPORATION EXHIBIT 2-A

OPTION VALUE OF THE NOTE
July 14, 1999

BEV CONTINGENCY - CALCULATION OF CONTINGENCY FAIR MARKET VALUE

Year End	Probability of Achieving BEV Contingency		Present Value of Payments if Contingency Achieved		Expected Value of the Contingency Payments
	Exhibit 2-1A		Exhibit 2-2		
1998	0.00%	x	470,865,664	=	-
1999	0.00%	x	443,712,749	=	-
2000	0.80%	x	418,807,638	=	3,350,461
2001	0.70%	x	396,680,361	=	2,776,763
2002	0.30%	x	376,571,038	=	1,129,713
2003	0.10%	x	357,531,660	=	357,532
2004	0.00%	x	330,745,710	=	0
Total	1.9%				$ 7,614,468

KINGSTON TECHNOLOGY CORPORATION EXHIBIT 2-B

OPTION VALUE OF THE NOTE
July 14, 1999

EBIT CONTINGENCY - CALCULATION OF CONTINGENCY FAIR MARKET VALUI

Year (t) End	Probability of Achieving EBIT Contingency		Present Value of Payments if Contingency Achieved		Expected Value of the Contingency Payments
	Exhibit 2-1B		Exhibit 2-2		
1998	0.0%	x	$ 470,865,664	=	-
1999	0.3%	x	443,712,749	=	$ 1,331,138
2000	0.4%	x	418,807,638	=	1,675,231
2001	0.3%	x	396,680,361	=	1,190,041
2002	0.3%	x	376,571,038	=	1,129,713
2003	0.3%	x	357,531,660	=	1,072,595
2004	0.0%	x	330,745,710	=	-
Total	1.6%				$ 6,398,718