Revenue Ruling 74-503 held that "[p]ursuant to section 1.1032-1(d) of the regulations, the basis of the stock of X received by Y and the basis of the stock of Y received by X will be determined under section 362(a) of the Code since the transaction also qualifies, for purposes of determining basis, under section 351. . . . Therefore, the basis of the X treasury stock received by Y will be the same as it was in the hands of X immediately prior to the exchange. In addition, the basis of the newly issued stock of Y received by X will be the same as it was in the hands of Y immediately prior to the exchange . . . . The basis of previously unissued stock in the hands of the corporation issuing it in a transaction to which section 362 of the Code applies is zero. . . . Accordingly, the basis of the X treasury stock received by Y is zero and the basis of the newly issued Y stock received by X is zero."

Rev. Rul. 74-503 was revoked by Rev. Rul. 2006-2. Rev. Rul. 2006-2 provides: "Rev. Rul. 74-503 states that X's basis in the Y stock received in the exchange is determined under §362(a) . . . . This conclusion is incorrect. Accordingly, Rev. Rul. 74-503 . . . . is revoked . . . . The other conclusions in the ruling, including the conclusions that X's basis in the Y stock received in the exchange and Y's basis in the X stock received in the exchange are zero, are under study."

Note that if X were to transfer cash to Y in exchange for Y stock and Y were to re-transfer the cash to X in exchange for X stock, and the transactions were not disregarded as a circular flow of cash, then X's basis in the Y stock and Y's basis in the X stock would equal fair market value.

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