Alfred Decker & Cohn, Inc. v. Commissioner, 22 T.C. 132 (1954)

When a corporation acquires its own stock subject to a significant option that depresses its fair market value, the basis of that stock for later determining gain or loss is the remaining amount of the debt for which the stock was received, especially if the stock's fair market value is not ascertainable due to the option.

Summary

Alfred Decker & Cohn, Inc. (petitioner) sought a redetermination of deficiencies in excess profits tax. The Tax Court addressed issues concerning the basis of treasury stock sold, the valuation of goodwill, borrowed invested capital, and accrued interest income. The court held that the basis of stock acquired subject to a 10-year option with nominal value was the remaining debt. It also determined the fair market value of goodwill and addressed the computation of borrowed invested capital and accrued interest income. The core issue revolved around determining the tax consequences of various transactions affecting the corporation's invested capital.

Facts

In 1934, the petitioner acquired 24,000 shares of its own common stock in cancellation of Alfred Decker's debt, which included paying Continental Bank $15,075 for 10,000 shares. As part of this deal, Raye Decker received a 10-year option to purchase these shares. In December 1943, Raye Decker exercised the option. The petitioner claimed the stock's basis was $133,438.55, the remaining debt. The Commissioner argued for a basis of $29,075, based on an assigned fair market value at the time of acquisition. The key factual element was the existence of a 10-year option that significantly impacted the stock's marketability.

Procedural History

The Commissioner determined deficiencies in the petitioner's excess profits tax. The petitioner appealed to the Tax Court, contesting the Commissioner's valuation of the stock basis and other aspects of invested capital. The Commissioner amended their answer, raising new issues, particularly concerning borrowed invested capital. The Tax Court reviewed the Commissioner's determinations and the petitioner's claims.

Issue(s)

1. Whether the basis of the 24,000 shares of treasury stock sold in 1943, which were acquired subject to a 10-year option, should be determined by the remaining debt owed by Alfred Decker or by an assigned fair market value at the time of acquisition.

2. What was the fair market value of the goodwill acquired by the petitioner from its shareholders in 1919 for purposes of computing equity invested capital?

3. Whether the petitioner's borrowed invested capital should include debentures at

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their face value or at the par value of the preferred stock surrendered in exchange for the debentures.

4. Whether the petitioner, an accrual basis taxpayer, must include in income interest due and payable on a note from its wholly-owned subsidiary, where there was a mutual agreement that no interest would be charged or paid until a future date.

Holding

1. No, because the stock was encumbered by a 10-year option rendering its fair market value unascertainable at the time of acquisition; therefore, the basis is the remaining debt.

2. The fair market value of the goodwill was determined to be $1,000,000 based on the past earnings, business conditions, and prospective future earnings.

3. Yes, the petitioner's borrowed invested capital should be computed by including the debentures at their face value, as the transaction converted equity invested capital into borrowed capital without statutory prohibition.

4. No, the petitioner is not required to accrue interest on the note as income, because there was a mutual understanding that no interest would be paid until a future date.

Court's Reasoning

The court reasoned that because the 24,000 shares of stock were encumbered by a 10-year option held by Raye Decker, they had no ascertainable fair market value at the time they were received. Citing *Gould Securities Co. v. United States, 96 F.2d 780*, the court determined that the basis should be the remaining portion of Alfred Decker's debt. The court noted, "Whether the fair market value of stock has been destroyed by an option will depend upon what kind of stock it is and upon the kind of option which has been granted and other relevant facts and circumstances of the particular case." With respect to goodwill, the court relied on factors such as past earnings, business conditions, and prospective earnings. On the borrowed invested capital issue, the court distinguished cases involving interest and found no statutory prohibition against converting equity invested capital into borrowed capital. As for the accrued interest, the court cited *Combs Lumber Co., 41 B.T.A. 839*, stating, "When the right to receive an amount becomes fixed, the right accrues.", and found that, due to a mutual agreement, the right to receive interest was not fixed.

Practical Implications

This case clarifies how to determine the basis of assets, particularly stock, when significant restrictions, such as options, affect their fair market value. It emphasizes that the existence and terms of an option can render stock's fair market value unascertainable. It provides guidance on valuing goodwill based on various

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economic factors. Furthermore, it confirms that taxpayers can convert equity into debt for excess profits tax purposes, absent specific statutory prohibitions. The case reinforces the principle that for accrual basis taxpayers, income accrues when the right to receive it becomes fixed, highlighting the importance of mutual agreements between parties.

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